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FOREWORD

These proceedings record the Tenth Annual Institute on Accounting at The Ohio State University. The general theme this year was "The Role of Accounting in Public and Industrial Relations." Interest in this conference of accountants, business executives, public officials, and teachers was marked by registration of approximately 550 persons representing the membership of leading state, national and international societies of the profession. Papers presented at this Institute and included in these proceedings will be published also in *The Journal of Accountancy*, *The Controller*, *The Accounting Review*, and in *The Accountant* (British). They constitute a valuable contribution to the literature of the profession.

The Eleventh Annual Institute on Accounting will be held May 20 and 21, 1949. Inasmuch as the academic year 1948-1949 marks the seventy-fifth anniversary of the opening of the Ohio State University, there will be a yearlong celebration to be known as the Diamond Jubilee. Hence, the Institution on Accounting to be held next year will be designated the Diamond Jubilee Institute. Plans are already being made for special celebration on that occasion. The faculty of the Department of Accounting works enthusiastically to organize and arrange these conferences and will be expecting to welcome back to the campus those who have attended in prior years, graduates now engaged in accounting and its related fields, and others who may wish to come to the campus for the first time.

Deep appreciatioin is expressed for the time and effort expended by speakers, chairmen of sessions, and others who so graciously assisted in making the success of the Tenth Annual Institute.

HERMANN C. MILLER
Chairman, The Department of Accounting

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FIRST SESSION

FRIDAY, MAY 21, 1948—10:00 A. M.

Hagerty Hall Auditorium

Chairman:

R. ALLAN PARKER, C.P.A., *Dayton, Ohio; President, The Ohio Society of Certified Public Accountants*

Address: "Presentation of Pertinent Data"

EARLE KING, *Chief Accountant, Securities and Exchange Commission, Washington, D. C.*

Address: "Building Confidence in Reports"

HARRY CASE, *Partner, Lybrand, Ross Bros. & Montgomery, New York*

Address: "Impact of Rising Prices upon Accounting Procedures"

SAMUEL J. BROAD, *Partner, Peat, Marwick, Mitchell & Co., New York*

PRESENTATION OF PERTINENT DATA IN FINANCIAL STATEMENTS

By EARLE C. KING
Chief Accountant, Securities and Exchange Commission, Washington, D. C.

The records show that the accountants of Ohio have been quite generous in their invitations to representatives of the Securities and Exchange Commission to appear before them on various occasions. Of particular interest to me is the appearance of the late Commissioner George C. Mathews's name in the list of speakers at your first annual institute on accounting. Since I was aware of this history of pleasant relations, I was very happy to accept the opportunity to appear here today and discuss some of our common problems in the presentation of pertinent data in financial statements.

A review of the proceedings of these Institutes on Accounting discloses that the field of accounting has been explored most thoroughly in special fields, as well as in the broader aspects, and that, from time to time, the subject of generally accepted accounting principles and their application to the end result of the accounting process—the financial statements—has been discussed.

The first session of your meeting in 1941 was devoted to the subject of "Accepted Accounting Principles." In introducing a progress report on the American Accounting Association's statement of accounting principles, the first speaker deplored the existing state of affairs as reflected in financial statements. Conflicting treatments of fixed assets, depreciation, reserves, inventories, capital stock, surplus, and profit and loss were cited. Dismissing the idea that it is impossible to reduce accounting to stated rules or standards, the speaker allied himself with that group of accountants who "have consistently held that there is great need for a statement of principles, and that this statement should come from the profession rather than from the SEC or other governmental agency."

From the outset, the Commission has been sympathetic to this point of view and has sought the advice of leading accounting authorities in teaching, public practice and among executives of corporations, investment bankers and financial analysts, in the preparation of rules, regulations and forms necessary in the administration of the Acts, which authorize the

Commission to prescribe the forms, items and details of financial statements to be filed generally, uniform systems of accounts (as for public utility holding companies), and "a reasonable degree of uniformity in the accounting policies and principles to be followed by registered investment companies in maintaining their accounting records and in preparing financial statements." Except to the extent indicated for the special fields mentioned, we have not attempted a comprehensive statement of accepted accounting principles. On individual problems, however, where our experience has disclosed serious discrepancies in practice as between companies and accountants, and where we have felt that uniformity in procedure would benefit investors, our conclusions have been expressed by rule or regulation of the Commission, or in an opinion of the Chief Accountant. The principal requirements of this type are published in Regulation S-X relating to the form and content of financial statements, and in our Accounting Series Releases.

Our approach to this problem of uniform application of accounting principles, I believe, is a necessary, practical recognition of conditions found in business and the accounting profession. Under the direction of the Commission, the administration of our accounting rules is entrusted to members of the staff who have had experience in business or in professional practice of accounting, and are, therefore, familiar with the problems involved in recognizing exceptions to those generally accepted accounting principles, in conformity with which the independent accountant asserts the financial statements have been prepared, on a basis consistent with that of the preceding year.

While we recognize that the American Accounting Association's statement of principles has not received unanimous endorsement by practicing accountants, we, nevertheless, find it to be a helpful document and guide in testing our own thinking on many problems. The American Institute of Accountants has been less bold on this subject than the teachers of accounting, and, as a body, has given recognition to only six unintegrated "rules" which were adopted in 1934.[1] These rules and the content of the succeeding Accounting Research Bulletins, with which you are all familiar, have, likewise, been extremely helpful guides in our accounting work, although we have taken exception to some of these pronouncements, particularly those which fail to take a clear-cut position with respect to the treatment of items in the determination of income.

Returning now to Regulation S-X, for the benefit of those who may not have had to use it, I want to emphasize that the rules contained in it

[1] See *Accounting Research Bulletin No. 1*, issued in September, 1939.

prescribe the method of presenting pertinent data in financial statements to be included in registration statements and reports to be filed with the Commission. Regulation S-X does not prescribe a uniform system of accounts, except that under the Investment Company Act of 1940, the prescription of the form of preparing financial statements of investment companies has the effect of "providing for a reasonable degree of uniformity in the accounting policies and principles to be followed by registered investment companies in maintaining their accounting records . . . "

It should also be noted that railroads, operating public utilities, and banks and insurance companies subject to state or federal supervision comply with the reporting requirements of Regulation S-X by filing part of all of the statements, or statements complying with uniform systems of accounts, prescribed by the other agency having jurisdiction. Such statements are subject to the rule, however, that "The information required with respect to any statement shall be furnished as a minimum requirement to which shall be added such further material information as is necessary to make the required statements, in the light of the circumstances under which they are made, not misleading."

At this point, it may be appropriate to consider the question of footnotes as a means of supplying "pertinent data." A short time ago, we had a letter from a student of accounting who was engaged in writing a paper on this subject. This student desired to confirm his impression that the SEC was opposed to footnotes to financial statements. I think we have, on occasion, deplored the incomprehensible language and the length of some of the footnotes accompanying financial statements filed with us. However, Regulation S-X recognizes that there is much pertinent data which should be disclosed with respect to the financial statements which, by its nature, cannot be conveniently incorporated on the face of the statements. I am convinced that the activities and financial problems of most of our large corporations, and to a lesser extent the smaller corporations, are so complex today that much of the significance of the financial statements would be lost without careful consideration of the content of the footnotes. I cannot imagine returning to financial statements without footnotes, and relying on the auditor's "certified correct," or, perhaps, a treasurer's similar statement subject to the warning "E and O. E." In addition to the footnotes, we require schedules in support of certain balance sheet and profit and loss items. The schedule of supplementary profit and loss information is the only one for an industrial company required to be included in the prospectus; and this may be accomplished in a footnote by even the largest corporations.

Recent examples of the treatment of footnotes may indicate the importance of the material disclosed. An annual report of a manufacturing corporation, filed on Form 10-K, included a balance sheet showing total assets of $9,000,000. The single footnote appeared on the face of the statement, and related to contingent liabilities in connection with pending suits against the company. The same item appeared in the published report to stockholders. The related profit and loss statement required two notes under our rules; one relating to inventories; and the other, to the depreciation policy of the company. Neither of the notes appeared in the report to stockholders.

The published report to stockholders of a progressive corporation with total assets of approximately $40,000,000 carried one note on the balance sheet relating to the borrowing of funds for the expansion of plant. The profit and loss statement carried two notes; one relating to Section 722 claims, and the other, to the inclusion of profits of a new subsidiary. A prospectus for this company, using the same financial statements, required five additional notes to the balance sheet; two related to principles of consolidation, one, to valuation of assets, one, to increase in the company's authorized capital stock (covered in the president's letter in the published report) and one, we required with respect to the use of a reserve for possible future inventory price declines. Six notes to the profit and loss statement in the prospectus included supplementary profit and loss information, inventory data, depreciation policy, equity in subsidiary profits not consolidated, the Section 722 claims, and awards under a management profit-sharing plan. All of the information disclosed seemed to me to be pertinent and useful to financial analysts. A sampling of 1947 annual reports to stockholders discloses that many of our largest corporations manage to get the notes to financial statements on one printed page, set up in a most readable style. Notes common to most reports include principles of consolidation, foreign operations, inventories, taxes and contingent liabilities.

A recent prospectus and annual report of Swift & Company presents, within the experience of one company, most of the outstanding problems currently under discussion. An important requirement of Regulation S-X is the disclosure of any significant change in accounting principle or practice, and an explanation, if the change substantially affects a proper comparison with the preceding year. The independent accountants call attention in their certificate, to a change in method of valuing *Lifo* inventories, and the notes explain the substantial effect. Although the adjustments made were believed to affect prior years to 1941, the entire correctioin of approximately $5,000,000 was made as a charge to 1947 income, shown separately in the prospectus income statement, but merged in cost of sales in the report to stockholders. The adjustment was shown as a special charge in 1947 in the ten-year summary of earnings, because, as a note states, of the impracticability of determining the amounts applying to the six individual prior fiscal years.

Lifo inventories are a feature of an extensive note on reserves in the prospectus. The note explains the presence among current liabilities of an item, "Reserve for replacement of basic 'Lifo' inventories (net after income taxes)," which arises from the adoption during 1946 of procedures relating to replacement of basic inventory quantities, involuntarily reduced because of the war emergency. The resulting adjustments were material, and affected income from 1941 through 1947, appropriate corrections being made in the summary of earnings and the three-year income statement, with related adjustment of tax claims—also a material item.

Three other reserves covered by the note in the prospectus, but without comment in the published report, appear immediately above "Capital Stock and Earned Surplus," under the caption "Reserves," qualified in the prospectus only in parentheses, "Appropriated from earned surplus":

General reserve	$16,000,000
For high cost additions to fixed assets	12,000,000
For inventory price declines	5,767,000
	$33,767,000

A still better presentation of these items, in my opinon, would be to show them as a subdivision of earned surplus as I have seen done in the report of one large corporation.

These three reserves are examples of the subject matter of the American Institute of Accountants' *Accounting Research Bulletins Nos. 28, 31,* and *33,* respectively. Footnote explanation indicates that the first item is a general-purpose contingency reserve of the type covered by *Bulletin No. 28,* which permits the showing of appropriations and return of appropriations to such reserves on the income statement after a clear designation of income, although expressing a preference for recording through the surplus account. I agree with the three members of the committee who thought that, despite every effort at clear disclosure on the income statement, many readers would be confused. Sometimes this confusion is compounded by the text of the report to stockholders which may infer that income should be considered to be the amount remaining after the appropriation to reserves.

Similar considerations apply with even more force, in my opinion, to the inventory reserve. Again, the Institute *Bulletin No. 31* favors the surplus segregation or appropriation treatment but recognizes as proper, but less desirable, the showing of the appropriation on the income statement. The Swift explanation of their reserve for inventory price decline states that the amount has remained unchanged since 1938, a year of price declines, in which $11,000,000 was restored to surplus from appropriations made in 1933, 1934, and 1935. The purpose of the reserve is stated to be: "This reserve was not made as against inventory carrying values at the close of the fiscal years but was primarily made as an appropriation of profits earned in a period of rising prices as a carry-forward to offset future losses or reduced profits in a period of declining prices, when and if such a condition should eventuate. It is not the Company's intention to utilize this reserve to absorb inventory losses which are properly allocable to future periods." That appears to be a clear-cut application of the procedure favored in *Bulletin No. 31,* and required by the Commission.

The reserve "For high-cost additions to fixed assets" reflected on the balance sheet was provided in 1947 and shown on the income statement in the prospectus as "Appropriation for high-cost additions to fixed assets," following a caption clearly designated "Net Income," with the remainder designated "Balance to earned surplus." In this case, the company uses a combined income and surplus statement, completing the statement in four lines by adding the opening balance, deducting dividends and arriving at "Earned surplus at end of period." The summary of earnings is in accord with this treatment but footnotes the "Net Income" by observing that $12,000,000 has been appropriated to reserve "For high-cost additions to fixed assets."

It is pertinent to observe that the annual report to stockholders, published months before the prospectus, contains a combined "Statement of Consolidated Income and Accumulated Earnings" which is a fair sample of the confusion the Commission recognized could arise in the application of *Accounting Research Bulletin No. 32* when the staff was authorized to take exceptions to financial statements which appear to be misleading, even though they reflect the policy laid down in the bulletin. For example:

"Net Income for the Year (see reserve appropriation following)		$ 34,334,977
Provision for high-cost additions to fixed assets		12,000,000
Amount of Net Income transferred to Accumulated Earnings		22,334,977
Other additions to and deductions from accumulated earnings:		
Reversal of reserve for deferred maintenance of properties	$3,000,000	
Adjustment of prior years' Canadian taxes and subsidies	426,703	
	$3,426,703	
Exchange adjustment in converting net assets of Canadian subsidiaries into U. S. dollars	1,012,974	2,413,729
		$ 24,748,706
Accumulated Earnings, October 26, 1946		119,143,149
		$143,891,855
Dividends Paid During Year, $2.10 per share		12,436,612
Accumulated Earnings, November 1, 1947		$131,455,243

(See Notes to Financial Statements)"

What the reader is intended to take as Net Income is further confused by turning the page in the report to a fifty-year financial record in which, for 1947, the figure of $24,748,706 is shown in the earnings column, and reduced to $4.18 per $25 share, and 1.1 cents per dollar of sales. A footnote to the amount of earnings reads:

Includes reversal of reserve for deferred maintenance of property of $3,000,000; less Canadian tax and exchange adjustments of $586,281 net, and after provision of $12,000,000 for High-Cost Additions to Fixed Assets.

The president's report to the shareholders includes the following paragraph:

Earnings Reflect Successful Year—Net earnings from all operations were $22,334,977 after provision of $12,000,000 for high-cost additions to fixed assets. (See special reference under financial position, Page 6.) Although our net earnings were larger than a year ago, our earnings per dollar of sales amounted to one cent, as compared to 1.3 cents in 1946. (For the distribution of Swift's average 1947 sales dollar, see chart on Page 5.)

The piechart shows "Remaining as Earnings 1.0¢," and the reference on page 6 is: "Under normal conditions the depreciation heretofore provided would have been sufficient to cover the cost of current replacements. However, because of the present abnormal price level it was deemed prudent to set aside a reserve for high-cost additions to Fixed Assets of $12,000,000." On page 2 of the report, "Financial Highlights" presents a five-year comparison which includes Earnings for 1947 as $22,335,000 footnoted "After provision of $12,000,000 for high-cost additions to fixed assets," and per-share earnings $3.77, and per-dollar-of-sales, 1¢. Here we have three figures reported as net income or earnings for the year with the smallest emphasized in the text of the report.

Perhaps this sort of thing is what the editors of the *Journal of Accountancy* had in mind in February of this year when they wrote under the title "Appropriations of Income and Earnings Per Share":

Recent reports of a number of companies . . . have violated the spirit and intent of this well-considered accounting convention [that provisions for vague or highly discretionary reserves should not be permitted to affect the reporting of net income], even while appearing to observe its letter. When a reserve of the type under discussion is provided as an appropriation of the current year's income, rather than of surplus, the wording describing the provision, and the balances before and after its deduction, become highly significant. When the final balance transferred to surplus is so captioned as to appear to be the net income, or is elsewhere cited as though it were the net income of the year, or is used as a basis of computing earnings per share, the purpose of excluding the provision from the determination of net income tends to be defeated, . . .

and that

The basic principle which requires the exclusion of "appropriations" from the determination of net income is clearly violated when the computation of earnings per share is based on the balance remaining after their deduction. At best this practice is confusing; at its worst it can be seriously misleading.

In discussing the Swift report and prospectus, reference has been made to the summary of earnings in the latter and to the fifty-year financial record and five-year financial highlights in the former. These are useful devices for presenting pertinent data concerning the growth of the business, but require careful compilation in order to assure reasonable comparability. This subject was covered very briefly in a footnote to our Accounting Series Release No. 62 with respect to the circumstances under which independent public accountants may properly express an opinion as to such summaries. This footnote reads:

Ordinarily, the summary earnings table will reflect the operations of the registrant, or of the registrant and its subsidiaries, during the period covered. However, under special circumstances, as where the registrant has succeeded to the business of one or more predecessors, it may be necessary for the summary to be especially constructed so as to reflect as far as possible for the period covered the earnings applicable to the enterprise now represented by the registrant. Where, for example, a predecessor operated as a partnership it is ordinarily necessary to indicate in an appropriate manner the adjustments required to place the partnership income on a corporate basis. In other unusual cases there may have been such violent and radical changes in the business of the registrant that a long summary of past earnings might be of very little or no value and might well be misleading. In several such cases, the registrant has been requested either to delete the summary entirely or to furnish only a brief statement of the over-all, aggregate results, without a breakdown as between the several years. In any case, where special and unusual circumstances exist, a decision as to the content of the summary and as to whether or not a summary should be furnished at all can only be reached after careful appraisal of the particular facts of each case.

An interesting application of the principles set forth in this footnote appeared in Chrysler Corporation's first quarter financial statement, published in the (Washington, D. C.) *Evening Star*, May 8, 1948. The "Comparative Consolidated Statement of Net Earnings (for the) Three Months Ended March 31" included the years 1948, 1947, 1946 and 1941 "in which the principal activity of the Corporation and its subsidiaries was the manufacture and sale of automotive products."

Another variation of the idea appeared in the 1947 annual report of Standard Oil Company (New Jersey), in which a Financial and Operating Summary compared 1947, 1946 and the average for 1941-1945. Whether an average for any period is a suitable basis for comparison must depend on the character of the business during the period, as, in some cases, a showing of fluctuating results from year to year may be more representative of the character of an enterprise than an average.

Reverting again to Regulation S-X, let us consider Rule 3-01 of which section (a) provides that "Financial statements may be filed in such form and order, and may use such generally accepted terminology, as will best indicate their significance and character in the light of the provisions applicable thereto."

Article 5 of Regulation S-X governs the form and content of financial statements for all persons except investment companies, insurance companies, committees issuing certificates of deposit, banks, and companies in a developmental or exploratory stage for which special instructions are provided in the regulation or in the forms required to be filed. The form, order and terminology adopted in this article for the balance sheet and profit and loss statement may, I believe, be considered a proper reflection of generally accepted practice at the time of its adoption (1940), as the regulation was subjected to extensive and intensive criticism by all interested parties prior to promulgation.

The balance sheet is presented in a current-to-fixed order, and the profit and loss or income statement presents a showing, in order, of sales; cost of sales (or operating revenues and operating expenses where appropriate); other operating expenses; selling, general, and administrative expenses; other income; income deductions—arriving at net income before and after provision for income and excess profits taxes. An analysis of surplus is required, either as a continuation of the related profit and loss statement or in the form of a separate statement of surplus.

It should be observed, at this point, that sections 7 and 10 of the Securities Act of 1933 require a registration statement and prospectus to include the financial statements prescribed in Schedule A of the Act. This schedule permits the Commission considerable latitude as to form and detail of the financial statements, but requires specifically that the profit and loss statement shall "differentiate between any recurring and non-recurring income and between any investment and operating income." The Securities Exchange Act of 1934, in Section 13 with respect to periodical reports, provides that the Commission may prescribe similar requirements. Under the 1933 Act, serious consequences may result if the financial statements contain any untrue statement of a material fact, or omit to state a material fact required to be stated therein or necessary to make the statements not misleading. A similar admonition appearing in the 1934 Act provides penalties in case a statement, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact.

It will be recognized that the Regulation S-X option of combining the profit and loss and surplus statements in one statement is in accord with the trend at the time, as reflected in *Accounting Research Bulletin No. 8*, issued by the A. I. A. Committee on Accounting Procedure in February, 1941. This bulletin, however, warned against the danger of obscuring the net income figure. With the publication of *Accounting Research Bulletin No. 32* in December, 1947, this warning becomes extremely important since, as I stated in a letter to the Director of Research of the Institute, dated December 11, 1947, which was published in the January, 1948 *Journal of Accountancy*, the Commission has authorized the staff to take exception to financial statements which appear to be misleading, even though they reflect the application of this bulletin. The discussion of the Swift report seems to me to indicate that this apprehension was well founded.

Developments, during the war, in the method of doing business—in many cases, practically complete conversion to war contracts—and a growing inquisitiveness on the part of labor concerning facts about the business, put pressure on corporate officials and their accountants to devise a new form of profit and loss statement, and a substitute for the balance sheet form of statement of financial condition. The "single-step" form of profit and loss statement was the first to come to our attention, and to be given serious consideration.

This new form of profit and loss statement was offered by several prominent and large corporations as full compliance with Regulation S-X, Rule 3-01 relating to form, order, and terminology being cited in justification for the departure from the forms previously filed in the order set forth in Article 5 of the regulation. A group of leading independent accountants appeared informally before the Commission to urge that Regulation S-X be amended so as to permit wide freedom in the form and order of the profit and loss statement. After study of the matter, the Commission reached the conclusion, with respect to this proposal, that its rules as to form and order of statement should not be changed.

Three reasons were given. First, it was felt that a convincing case had not been made in favor of the proposed new form and order. Second, it was believed that the new ideas had not yet gained sufficient recognition in actual practice to warrant adoption by the Commission in the face of its own doubts. Third, the opinion was held that the proper place for experimentation of this kind was not in reports required to be filed with the Commission, but rather in the annual reports furnished by companies to their stockholders.

The Commission emphasized that it did not wish to be regarded as opposing constructive changes as such, that it was receptive to proposals of this character, and that, if and when the proposed form of profit and loss statement became generally accepted, its decision would be reconsidered.

The staff has applied these principles to the current proposals as to changes in the form of the balance sheet. It was agreed, however, as in the case of the profit and loss statement, that no objection would be made to the filing with the Commission of financial statements prepared in a form other than that required by Regulation S-X, *provided* that such statements were not misleading, and were furnished as supplementary data and not in lieu of the prescribed statements.

A common form of the single-step statement begins by grouping all "revenues" from which is deducted a single total of costs and expenses, itemized to show components of employment costs, materials and services purchased, provision for depreciation, interest charges, sundry taxes, and federal income taxes, and arriving at "Income for the year" from which dividends are deducted leaving "Income Retained in the Business." A variation of this form introduces the beginning and ending inventories in the determination of "Costs allocated to the year."

The criticism of a New York security analyst published in the *Journal of Accountancy* for November, 1947 applies to both of these forms. He said:

At least the main items of cost, wages, materials, selling, distribution, and administrative expenses, might well be listed separately in corporate annual reports.

This enables important operating and expense ratios to be calculated, year-to-year trends noted, and comparisons to be made with similar ratios of other companies in the same line. Such comparisons greatly aid in distinguishing the most efficient from the least efficient and high-cost enterprises. Of late there has been a deplorable tendency on the part of some major corporations to lump together "cost of goods sold" and "operating expenses" and to omit entirely the "gross profit from operations." One or two steel companies in the past year or two that previously provided a fair amount of detail in this respect, have recently lapsed. The analyst is not enthusiastic about such tendencies.

Having in mind the source of this comment, and the fact that, in the Commission's administration of the Securities Acts, we are required to insist upon financial statements which will be most useful to investors, I think it is clear that the forms presented above are unsatisfactory in several respects. Both statements fail to differentiate between recurring and nonrecurring income (assuming the latter was present), and between investment and operating income. In the second example, interest expense is netted against interest income and the balance listed as an offset to "costs incurred." In the first example, there is no indication of how the increase or decrease in inventories has been handled, and both are obscure as to the items which constitute the cost of inventories and cost of goods sold. There is a possible inference, particularly in the second example, that all items listed as costs incurred may enter into the cost of inventories. This is not a too farfetched assumption, for examples have come to our attention in which selling, general and administrative expenses have been included in inventories and cost of goods sold. The practice seems to be a carry-over from war-contract-accounting practice, wherein all recoverable costs under the contract were charged thereagainst. With the reconversion to peace-time operations, we think this practice is no longer appropriate, and that the principle of excluding from inventories selling, general and administrative expenses not applicable to production, as laid down in the *Accounting Research Bulletin No. 29* on "Inventory Pricing," should be applied.

Some of these new-style income statements have substituted everyday language (apparently considered to be more understandable to lay readers) for technical accounting terms. The use of "received from customers" and "paid for" elements of cost connotes a cash basis of accounting which surely is not intended. The general idea of simplification expressed in these statements had been used for a number of years prior to the war in special reports prepared for employees, or as a basis for "pie" charts or other pictorial forms of presentation in the president's letter. I think this use is appropriate as a supplement, not as a substitute; but before even subscribing to such limited use, it should be made certain that the interpretive value of the conventional style of profit and loss statement is not in the process of being subordinated to the anticipated propaganda value of the new style. Nor am I ready to concede that informed stockholders and financial analysts should be confined to a form of reporting designed to meet the needs of those unfamiliar with the terms and principles of corporation finance and accounting. Instead, I think we should encourage more investors to learn these principles.

In concluding this consideration of the profit and loss statement, it may be mentioned that under the Securities Act our registration forms for mining companies in the developmental and exploratory stage and industrial companies in the promotional stage require the submission of statements of cash receipts and disbursements instead of profit and loss statements, as, in most such cases, the latter would be much less informative than the former. We also have under consideration the extension of this idea to annual reports for such companies.

Experimentation with new forms of statements of financial conditions as substitutes for the balance sheet is not new, for companies in the developmental stage. The forms just referred to provide for separate statements of assets and capitalized expenses, liabilities, and capital shares. The reshuffling of the balance sheet for large and well-established corporations, however, seems to be a more recent development. The question as to the acceptability of these new forms, generally referred to as narrative statements, as compliance with the balance sheet requirements of Regulation S-X, has arisen since the close of the recent hostilities. As I have indicated above, in some cases, we have not objected to the filing of the new form as additional information, but, at the same time, we have required a statement in the customary balanced form. In others, we have felt that the new-style form was inappropriate and could not be accepted because of its misleading characteristics.

Generally speaking, we have the feeling that the narrative form violates the principle that specific liabilities, or classes of liabilities, as a rule, are not claims against specific assets or classes of assets. The problem is not particularly serious in a company which is not only financially sound but in which all liabilities are current and are exceeded substantially by the current assets. We have more difficulty as the margin grows narrow, and question entirely the propriety of the narrative style when long-term debt is present. Occasionally, a form of debt crops up that is difficult to classify, even on a balanced form of statement. In such cases, the narrative form may give a definitely misleading result.

The statement of changes in working capital or sources and application of funds, I think, is a useful form of presentation in connection with the balance sheet, as well as with the narrative form of statement. In fact, the changes in working capital seem to me to demonstrate the weakness of the new form, as they necessarily set forth that, in addition to net income as reported, the sources of working capital are reflected in all areas of the balance sheet—conversion of plant assets through depreciation or sale, disposal of investments, long-term loans and issues of bonds and stocks. Conversely, reductions of working capital may come from losses in operations, expenditures for plant or investments, repayment of loans, retirement of bonds and capital stock, and the payment of dividends. This flow of funds within the business, I believe, can be visualized more clearly and with less danger of misinterpretation by means of the balance sheet form than can be done in the narrative statement. It seems to me, therefore, that the narrative form is inappropriate except in the simplest situations.

BUILDING CONFIDENCE IN REPORTS

By Harry N. Case
Partner, Lybrand, Ross Brothers and Montgomery, New York City

The history of corporate reporting has seen many changes within the past twenty years. Prior to 1900 few corporations issued complete and informative reports on their affairs. Most corporate managements had adopted an ostrich-like attitude of withholding information on the grounds that it was confidential and would be beneficial to its competitors.

Although the New York Stock Exchange, for many years, had worked diligently for adequate disclosure of financial information, it apparently made little progress until 1900. Each year thereafter an increasing number of listed corporations agreed to make financial information available to their stockholders. United States Steel, General Motors and other great industries first adopted the theory stated by Judge Elbert Gary—"Corporations cannot work on a principle of locked doors and shut lips."

After the stock market crash in October, 1929, public clamor arose for strict accountability on the part of management, and brought about the enactment of the Securities Act of 1933, and the Securities Exchange Act of 1934. These acts provided for the reporting by substantially all listed corporations—and later by many unlisted companies—of complete and detailed financial information considered necessary to adequately inform an investor.

Prior to 1933, the need of an examination of a corporation's financial statements by independent public accountants was a matter decided largely by management. In 1933, the New York Stock Exchange announced that all listing applications must contain certificates of independent accountants applying to the financial statements, and that such listing applications must contain an agreement that future annual reports to stockholders would contain a similar certificate.

Corporate annual reports are read by thousands of investors and prospective investors. The importance of these annual reports makes it mandatory that they be received with confidence—confidence in their accuracy and integrity.

Certainly, the management of an enterprise whose reports are viewed with suspicion or with lack of confidence has failed in the discharge of his duties. Happily most corporate reports today are accepted for what they are—namely, a fair accounting by management of its stewardship. I regret to say, however, that I have seen evidence within the past few years that a few corporate reports were issued which were, deliberate or otherwise, inaccurate and misleading.

It seems to me that if corporate reports are to be received with confidence, they must meet three general rules: (1) they must tell the truth—the good and the bad; (2) they must be informative; and (3) they must be understandable.

Few corporate reports today are open to the charge that they are completely inaccurate or misleading. I think, however, some reports are open to the charge that, although the truth is there, it can be found only after patient and exhaustive reading and analyzing. Many reports attempt to paint a pretty picture of corporate affairs, rather than to present an informative display of facts and interpretations of what the company has done.

There has been a disturbing situation in several annual reports recently released which I hope will not continue. I have noticed several reports in which the figure of net income discussed in the president's letter, or included in condensed statistical comparisons, differs from that reported in the financial statements included in the report. As you know, many corporations have provided reserves for future inventory losses or for unforeseen contingencies in future periods. Present accounting practices provide that such reserves should be appropriated from net income or surplus, and that provisions for reserves of this type should not be a factor in determining net income. I hesitate to say that an annual report in which the financial statements reflect an appropriation of income for a reserve of this type, but in which the president's letter discusses net income as the figure after such appropriation, is actually misleading. However, if it is not misleading it certainly represents calculated ambiguity, or, at least, the practice of rugged individualism on the part of the corporate official. Neither has any place in corporate reporting.

Although, the number of companies presenting financial information to investors gradually increased, beginning with the year 1900, the quality of corporate reports has shown a marked improvement in the last five or ten years. A few years ago, most annual reports were noted for their brevity. An informative report, judged by today's standards, was the exception rather than the rule. Many statements of income started with a figure of operating income which was after practically all charges. Balance sheets, although somewhat more informative, were similarly brief. The emphasis seemed to be on asset values underlying investments.

With more and more emphasis being placed on the earning capacity of a corporation, it seemed that the quality of corporate reporting also increased. Reports became more complete and more informative, and, consequently, more meaningful and useful.

There are still many companies which do not furnish all the information necessary for a fair appraisal of where a company has gone, and where it might go in the future. I will not attempt to state examples of incomplete reporting except to say that the most common appear to be the failure to give comparative financial information, to disclose information regarding sales and costs, and to give information regarding management policy which cannot be reported by the issuance of financial statements only. Standards of informative corporate reporting have been met not by one but by scores of companies. Reports of companies which do not meet such standards are bound to suffer by comparison.

Most of us tend to view with suspicion things we do not understand. Making reports more understandable and, therefore, more useful will, I believe, do more to increase confidence in corporate reporting than any other development.

When the problem of making reports more understandable is discussed, the most natural question is—understandable by whom? Certainly, a report should not be prepared so that it is understandable only by the the trained technician, or by the financial consultant or advisor. Nor should it be drafted so that it is understood, as some companies have stated their intention of doing, by a ten-year old. Any report directed to the latter would be so oversimplified that it would be incomprehensible.

Any report to stockholders should be presented in such manner that it can be understood by an investor having a basic understanding of the complexities of modern business and a knowledge of accounting fundamentals. A stockholder should not have to be a trained accountant or a technician to be able to interpret the data presented in an annual report, or to appraise intelligently the financial data included.

When I stated that, in my opinion, the most important contribution to increased confidence in reports would be to make such reports more understandable, I did not mean changing the existing format of a report, or using different adjectives or descriptive material. It appears, rather, that certain fundamental and basic differences of opinion among and between accountants and corporate officials must be resolved, and more uniformity in corporate accounting presentations achieved.

Differences of opinion on accounting matters tend to confuse the reader of a financial statement, particularly when he is comparing the financial statements of several companies. Certainly, one of the objectives of good corporate reporting should be to make financial statements comparable.

Certain differences of opinion among accountants have resulted in the acceptance of alternate solutions of similar problems, and, consequently, alternate methods of presentation in corporate financial statements. In 1945 and 1946, many companies incurred significant nonrecurring losses resulting from the cessation of hostilities which were charged to surplus or to reserve accounts. The treatment of the reduction in income taxes attributable to such extraordinary losses reflected the versatility of the accounting profession. I recall seeing annual reports of three companies for the year 1945, each reflecting an extraordinary charge of the same general nature. Company A reflected the actual income tax liability for the year in its income statement, and explained in a footnote the effect of the extraordinary charge on income taxes. Company B reflected an artificial income tax liability in its income statement and credited the difference between this amount and the actual liability (such difference being attributable to the extraordinary charge) to surplus. Company C reflected the actual tax liability in its income statement, and also reflected as a special charge that portion of the extraordinary loss equivalent to the reduction in income taxes—the same problem having three solutions, with solution No. 1 producing a different net income.

I realize that the illustration I have just given applied to a situation which existed during the year the war ended—a year in which many companies were beset with so many problems that it was a wonder they were able to issue reports which made any sense. There is reason to believe, however, that many companies will have similar problems in the future, and so far as I know, each of the three methods is still acceptable.

Each of the three methods of dealing with the problem I mentioned has many supporters and strong arguments can be advanced for each case. There are many other matters about which corporate officials and accountants have not agreed, and, consequently, we find different solutions of many similar problems in annual reports to stockholders.

I am not advocating that the accounting profession be so regimented that there can be only one way of solving every problem regardless of circumstances. I do think we should strive for the universal acceptance of one method of handling the matters about which there is present divergence of opinion, so that alternate methods become the exception rather than the rule, and only where they can be justified because of particular circumstances. Versatility is a remarkable trait, but let's consider the investor who is searching for information to make a good investment of his hard-earned dollars.

Can these differences of opinion be resolved, and can we have more uniformity in dealing with problems about which we now differ? I think they can. For many years accountants have differed on the respective merits of the "all-inclusive" versus the "operating-concept" type of income statement. Consequently, both approaches have been adopted by many corporations in their reports to stockholders, with resulting problems of comparability and confusion to many readers. Within the past few weeks, the Committee on Accounting Procedure of the American Institute of Accountants, which includes many of the outstanding thinkers in our profession, concluded weeks of discussion which resulted in the issuance of such a bulletin which should provide for more uniformity in financial reporting. The Committee recommends that there should be a general presumption that all items of profit and loss, recognized during the period, are to be used in determining the figure reported as net income. The Committee also recognizes that certain items which are materially significant in relation to the company's net income, and are clearly not identifiable with or do not result from the usual or typical business operations of the period, should be excluded from the determination of net income. As these bulletins are generally accepted as representing sound accounting practices, the adoption of Bulletin 32 should result in more comparable financial statements.

No other profession has so many different terms which mean the same things as the accounting profession. Realizing this situation, many companies have, in recent years, adopted a new approach to corporate reporting. This approach consisted of a rearrangement of the items appearing on the financial statements, and the substitution of more commonly used words for the technical terms that had developed within the accounting profession. In many respects, it is regrettable that the pioneers in simplified corporate reporting worked independently, for they are now a law by themselves. As a matter of fact, even those companies which departed from the conventional methods of presentation, in order to simplify financial data, found that such financial statements were not always received with confidence.

An editorial in the March, 1948 *Journal of Accountancy* deals with the point in question. That editorial pointed out that the Caterpillar Tractor Company, in releasing its recent financial statements to the press, requested editors to preserve the form and terminology which the company had adopted. The editorial further stated that one financial editor took this request to mean that the company had something to hide. He published a denunciation of the company's request that the statements be not recast "into more conventional forms which the company has elected to abandon." He then proceeded to reveal what he thought were hidden profits the company was trying to conceal. Two days later the same financial editor published a complete retraction and an apology.

The point the editorial made was that sometimes even men with the technical training of financial editors can become confused about accounting data. It is small wonder then that stockholders not possessed of a technical background find many corporate reports confusing.

In many respects the action of certain companies in abandoning the conventional forms, laudable as their objectives were, has served to increase the confusion in the minds of many investors. The statement of assets, liabilities and capital reflecting the financial condition of a company is now called: (1) balance sheet; (2) statement of financial condition; (3) statement of financial position; and (4) investment. It may be of small importance to some of you that a statement setting forth the same facts is called by many different names. It does not make sense to me.

What is needed is not individual action but concerted action—concerted action on the part of the accounting profession and corporation officials—to insure more uniformity of corporate reporting. We do not want standardization by any stretch of the imagination, but we do want corporate reports to be more meaningful and more comparable.

James J. Caffrey, in a paper presented at the 60th Annual Meeting of the American Institute of Accountants, said:

> When accounting terminology loses touch with common meanings, it becomes at best a verbal exercise and at worst meaningless double talk. Who is to blame if balance sheets and income statements of the X and Y companies are found to use the same language to describe different things. There may be excellent arguments to justify both presentations. However, if they use the same words to describe different things, even an experienced investor who makes a comparison between them may be seriously misled by a dangerous, though honest, falsehood. Each statement, telling the truth in its own way, is justifiable; put together, they distort each other.

I think Mr. Caffrey's words aptly sum up a very serious challenge to the accounting profession. It is a challenge that can and should be met.

The views I have presented on building confidence in reports are the views of a practicing public accountant. I am proud of the fact that the public accounting profession has, in the past, done so much to improve the quality of corporate reporting. We shall continue to do our part in the future.

THE IMPACT OF RISING PRICES UPON ACCOUNTING PROCEDURES

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Rising prices and reduced purchasing power of the dollar are two sides of the same coin and depend on the side we look at. As a result of the reduced purchasing power of the dollar, I think we have to recognize that the limitations of financial statements prepared in accordance with generally accepted accounting practices are greater today than they have ever been before in our country. I think it is important to try to understand how this has come about and to consider whether anything has been, or should be, done about it; and if so, what.

An assumption underlying accounting statements is that the dollar is a reasonably stable unit of measurement, and, even though we have recognized the varying purchasing power of foreign currencies by converting them into dollars at rates which may vary from year to year, it has never been considered necessary to recognize changes in the purchasing power of our own monetary unit.[1] So corporate capital and income have been measured in dollars without regard to what the dollars would buy when they were paid in, or what the income will buy when earned.

Increasingly, over the decades, we have stressed the importance of the income statement as an instrument which must be made useful, and in some important respects this has been done at the expense of the balance sheet. The amount of any expenditure properly chargeable against the income of current or past years has been determined, and the remainder has been carried forward in the balance sheet as an asset applicable to future periods. This is the basis on which unamortized bond discount is treated as an asset; it is the basis for our calculations of depreciation or amortization of property, plant and equipment; and more recently, it has been the basis on which the carrying forward of inventories determined by the last-in-first-out method has been justified. As a result, the balance

[1] Note, however, the following comment on the "cost principle," taken from *Accounting Principles Underlying Corporate Financial Statements* published by the American Accounting Association in 1941: "It should be applied with enough flexibility to meet business and financial needs under all ordinary circumstances. A marked change in the value of money might impair the usefulness of cost records; however, such changes in price levels as have occurred in this country during the last half century have afforded insufficient reason for the adjustment of asset values."

sheet has reflected to a continually lesser extent the current values of the assets, a departure which has been magnified by monetary inflation.

Our emphasis on income is well warranted. Comparative income figures, sometimes accompanied by sales figures, are the only figures usually reported in press releases. They are considered to be, and are, the figures of greatest importance to the public in its valuation of securities. Adequate working capital and a fluid position are also important; but for a stable company the asset figures are relatively unimportant otherwise, unless supported by earnings. The emphasis on income, therefore, makes it the more vital that the income figures reported be realistic and meaningful.

With occasional lapses, the dollar has been declining in purchasing power for as long as we can remember. This gradual process, however, was spurred greatly as a result of World War I and World War II. After World War I, prices reached a reasonably settled state again in a few years, but at a level considerably higher than before. During World War II we had a very much greater expansion of the national debt, and, while price increases were kept under control during the war, the release of controls was followed by a rapid spiral of advances. It is doubtful whether any responsible person thinks that prices are likely to decline permanently to their former level, or even within 50 per cent of it. The accounting problems brought by the decline in value of the currency will be with us as long as the accounts continue to reflect pre-war dollars.

We talk about money income and we talk about economic income. There is no great mystery about economic income, though it may be hard to measure. The basic distinction is clear if we look at it from the standpoint of the individual. This has been described as what a man can spend and still be no worse off at the end of the year than he was at the beginning. Whether he is, of course, will depend, for most people, largely upon the cost of living during the year. "Real" wages are measured by what they will buy. The lower purchasing power of money forced money-wage increases during the war, even in those countries which had imposed rigid controls. It has been accepted as the basis of wage negotiations in at least two rounds of wage increases. Sometimes the increases are frankly called "cost-of-living adjustments." People with restricted incomes have to think of their salaries or wages or investment income in terms of what it will buy, not merely how many dollars are involved. For the individual, then, it is economic income which counts, and not money income.

For productive enterprise, economic income has been described as the balance of revenue left after making provision for the cost of replacing materials and equipment used up in earning that revenue. Economic income arises from the *creation* of wealth. In contrast, accounting income emphasizes realization; it is founded on cost, not because cost is a truer measure, but because income cannot be spent until it is realized, and because the recognition of wealth created through real appreciation would create problems so great as to make the objective measurement of income impossible.

We should recognize that there are two kinds of appreciation. True appreciation is an increase in intrinsic value, actual as well as relative. Boulder Dam is wealth itself, but it also increased the real value of the surrounding territory to which water and electricity became available. A railroad crossed the prairies and the hunting grounds of the Indians became, first, ranches; later, fertile farms; and finally, manufacturing communities supporting large cities. The land became more and more valuable as more and more use was made of it.

Another kind of appreciation is more illusory than real. My own home, bought in 1927, declined sharply in selling value in the 1930's but two or three years ago I could have sold it readily for more than I paid for it. But I needed a home to live in and raise my family. If I had sold my house in 1932 and bought another one, I would have shown a money loss; if I had done the same in 1946, I would have shown a money profit. I leave it to you to decide whether either transaction would have left me better off or worse off. The point I want to make is that there was no real depreciation or appreciation in the intrinsic value of the house, but, rather, a change in the purchasing power of the dollar in which the sale would have been recorded. As you doubtless know, efforts are being made to get the Federal taxing authorities to recognize the unreality of such profits or losses and eliminate taxes on them.

Changing levels of the dollar affect different businesses to different degrees, depending upon the nature of their assets and liabilties. An installment finance company which has cash and receivables as its only assets and loans and other payables as its only liabilities will be little affected. Business generally, however, has a mixed aggregate of assets; partly, money assets, such as cash and receivables; partly, property assets in the form of inventories, property and equipment, and, possibly, intangibles; and partly, assets of a mixed character such as investments. Against these, it has liabilities and senior securities which are payable in money, including long-term debt and preferred capital stock, and the excess of the assets over these amounts represents the equity of the common stockholders. When inflation occurs, money liabilities and securities can be paid off in cheaper dollars, and, if they exceed the money assets, the common stockholders benefit; and vice versa. On the other hand, to the extent that the common stockholders' equity is represented by inventories and other property assets, there is a hedge against inflation. If the properties increase in money value, the money values behind the stockholders' equity increases too, though the intrinsic values may not be affected.

Inventories

Let us turn our attention to that portion of the common stockholders' equity which is represented by nonmoney assets, particularly inventories and plant and equipment; first, inventories.

We can approach the problem by a comparison of the effect of the first-in-first-out (*fifo*)[2] method and the last-in-first-out (*lifo*) method. Let me illustrate the difference by the example of a shoe merchant and a pair of shoes. The example is shopworn but it serves to illustrate the point. Our merchant starts the year with a pair of shoes which cost him $5. During the year two or three price advances occur, but he always gets enough when he sells one pair to pay his rent and expenses and buy another pair. At the end of the year, he has a pair of shoes left but this particular pair cost him $8. He makes up his income statement, and if he is on the *fifo* basis, he will show a profit of $3 and will owe taxes of, say, $1.00. He reports a profit of $2.00. If he is on the *lifo* basis, he shows the pair of shoes at $5 and no profit and no taxes. This comparison gets us down to the crux of the question: Is the merchant really better off by $2.00 than he was at the beginning of the year? He still has a pair of shoes similar to the ones he started with, but he now owes $1.00 which he did not owe before. Is it better that his profits be measured on this basis, which reflects monetary income, or on the *lifo* basis which allows for the reduced purchasing power of the dollar to the extent that it has been reflected in actual transactions, and, thus, more nearly reflects economic income?

Some accountants argue that the merchant has made a real profit if he call sell the last pair of shoes for more than he paid for it. But if the increased price of the shoes is reasonably indicative of the reduced purchasing power of the dollar generally, that is, unless the merchant can take his $8 and buy more bread and meat and clothes with it than he could with the $5 at the beginning of the year, it is hard to see how he is better

[2] While comparisons are made of the *lifo* method with the *fifo* method, similar comparisons with other methods, such as average cost, adjusted standard cost, etc., would be equally valid. These alternatives vary from the fifo method principally in the speed with which they reflect approximate current replacement cost in inventory prices and in profits.

off than he was before. Rather, he now has a debt for taxes which did not exist at the beginning of the year.

The basis on which *lifo* was originally adopted for tax purposes was that it was a method of limited applicability, being suitable only for companies whose inventories consisted, to a large extent, of homogeneous materials, and whose products took a considerable time to manufacture, a limitation which was overruled in 1947 in the *Hutzler Bros.* tax case. The limitation is tied with the idea that *lifo* is an assumption as to the flow of goods or the flow of costs. There has been considerable discussion recently as to whether that is really the basic justification for *lifo*, or whether the more tenable position is not that the method is valid because it results in matching current costs with current revenues, leaving the residual amount of historical cost to be carried forward in the balance sheet. As far back as 1936, the latter was stated by an Institute committee to be the "prime purpose of the last-in-first-out principle."[3]

Restrictions placed upon the use of the *lifo* method for tax purposes are perhaps necessary for effective administration, but, nevertheless, they are arbitrary and often accidental in their results; and, particularly, the requirement for an annual cut-off for quantities and prices. As a consequence, the *lifo* method in application has moved away in some respects from a sound theoretical basis. It has been criticized on this score and also on the score that, due to delays between the date of purchase and the date of sale, it may not result in an accurate matching of current replacement cost against current revenues. Despite its imperfections, however, it has

[3] See the report of the special committee on inventories of the American Institute of Accountants issued in 1936 which is illuminating as to the historical background of the *lifo* method. The report covers deliberations over a three-year period in collaboration with the sub-committee on inventory valuations of the American Petroleum Institute's committee on uniform methods of oil accounting. It contains numerous passages bearing on the question, of which the following is typical:

"The prime purpose of the 'last in, first out' principle, which the board of directors of the American Petroleum Institute has recommended to the membership of that institute, is to bring about, in the determination of profits in the financial accounts, a substantial correlation between sales prices and those raw material prices which have been directly causative of such sales prices.

"In its practical effect in the accomplishments of this objective, the 'last in, first out' principle may be viewed as comparable to the 'base stock' or 'basic inventory' method of inventory valuation, the purpose of which likewise is that the revenue from high sales prices be burdened with the costs causative of such high sales prices, and not leave high price level inventories to be absorbed later by revenue representing a lower price level, upon the turn of the economic cycle." (*Journal of Accountancy*, August, 1936, p. 128.)

The report also recognizes, apparently as a secondary result, an assumption as to the flow of goods or flow of costs:

"The 'last in, first out' method, however, extends its treatment to include the actual delivery out of inventory of goods replaced in such inventory by current purchases; in such case the method assumes, for the purpose of determining the cost of sales, that the goods delivered were those currently purchased." (*Ibid*, p. 131.)

served a very useful purpose, in that it has excluded from the income statement, to a substantial degree, the effects of price inflation.

The same cannot be said for the first-in-first-out method. Increases in inventory unit prices during the year have found their way into profits, and without separate identification. How ever much we may argue whether these increases represent real profits or not, there is no doubt that they are of a non-recurring or extraordinary nature. They do not belong in any figure used to judge earning power. The stock market has discounted such monetary profits, but it has had to do it without being able to do much more than guess at the amount involved.

There is much yet to be done to improve income accounting under both the *lifo* and *fifo* methods. As to *lifo*, perhaps something more akin to the base-stock method of valuation, that is, the application of a uniform price to uniform and normal quantities, is the direction in which we should move. Capital tied up in normal inventories is tied up just as permanently as capital tied up in plant.

Further, if *lifo* is intended, roughly, to match current costs against current income, it seems necessary that there be an extension of the practice of setting up reserves for replacement so as to provide them in all cases of inventory liquidation, voluntary as well as involuntary. At present the practice is common only in cases of involuntary liquidation, and even there has frequently been considered optional. This, undoubtedly, reflects the influence of tax regulations, which in this respect seem to be unduly restrictive. Failure to set up a reserve results in showing as monetary income in one period the results of accumulated price increase on the quantities liquidated, and, sometimes, corresponding monetary losses later. If there is to be a permanent reduction in quantities below the *lifo* base, the need for a reserve for replacement disappears, and it then becomes a question of how to disclose and where to reflect the monetary gain.

It seems unlikely that any companies which have not heretofore adopted *lifo* for tax purposes will do so now, because of the possibly serious tax disadvantages under present regulations. There is no reason, however, why a company could not, for the purpose of reporting to stockholders, use the *lifo* method (or the base-stock method, if that method should meet general approval) without adopting it for tax purposes. A number of companies have already done this because they believe it gives stockholders a more realistic picture of their operating profits. They have accomplished it by setting up a reserve objectively determined by the *lifo* or base-stock method.

Plant and Equipment

There are reasons to hope that prices may have about reached their peak. If this is so, the problem of monetary profits in income is largely behind us as far as inventories are concerned. Price advances have been shown as profits to the extent that they have been reflected in the inventories, they are included in surplus, and taxes have been paid on them.

Those companies which wished to exclude money profits resulting from the reduced purchasing power of the dollar have had available in *lifo* an alternative accounting method in respect to inventories. The same is not true as to plant and equipment. Generally accepted accounting practice requires that charges to income for depreciation or depletion be based on the dollar book figures despite recognition that the purchasing power of the dollar at the time the properties were acquired may have been substantially greater than when the charge is made. Sales, wages, rents and other income items in current dollars are thus mingled in the income statement with dollars of a different purchasing value. It is like having 100 oranges of revenue and deducting 80 oranges of costs and 10 grapefruit of cost and saying that the profit left is 10 oranges. We have developed no means for measuring grapefruit in terms of oranges. If the grapefruit were tangerines instead, perhaps it would not make much difference, but when the differential is large enough, we should consider whether it is not worth while to try to find some means of converting grapefruit into oranges so as to have a standard unit of measurement. There might be debate whether they should be converted on the basis of volume, or vitamins, or juice content. But even an imperfect basis of conversion would be more accurate than the bald assumption that the two are equal.

Possible alternative bases for depreciation charges are: consumption of original dollar cost or consumption of present dollar value or consumption of the present dollar value of the original dollar cost.

The Present Position

In December, 1947, the Committee on Accounting Procedure of the American Institute of Accountants issued, formally, as *Research Bulletin No. 33* a statement which had been published the previous October on the subject of "Depreciation and High Costs." This took the position that depreciation should continue to be based on cost; that provision for replacement was a financial problem which management might properly recognize by making annual appropriations of income or surplus; and that an increase in depreciation charges would not be "a satisfactory solution at this time." After discussing the formal recording of appraised current values, the Committee expressed the view that radical changes in accepted accounting procedure should be deferred until a stable price level would make it practicable for business as a whole to make the change at the same time. Recognition was given to the propriety of accelerated depreciation under certain circumstances.

Generally speaking, this line was held in 1947 financial statements. Despite protests, most corporations conformed, and most of those which did not form received qualified reports. Other treatments were adopted, however. A few companies charged off immediately what they regarded as excessive cost of current construction, taking the view that such losses occurred when the expenditures were made. One or two other companies increased depreciation charges to reflect, in part, in current dollars the amortization of expenditures made in dollars of a higher purchasing power. Still other companies adopted the practice of accelerating the depreciation of what they considered to be the excessive cost so as to provide for it over the period during which they expect to receive correspondingly high revenues.

These varying treatments adopted are part of what has been aptly described as a "scatterization of methods." Many appropriations or charges, more or less arbitrary in amount and reflecting basically different philosophies, were made, not only for plant replacement but also for inventory price declines and other purposes. There is grave danger that wide variations in practice and the deduction of arbitrary provisions will cast doubt upon the integrity of financial reporting and play into the hands of those who would like to see the private enterprise system discredited and government controls become more rigid.

SHOULD WE DO ANYTHING ABOUT IT?

Having reviewed the problems created by increased prices, the next step is to consider whether anything further should be done about it in the field of accounting. There is much evidence bearing upon this question.

The United States Department of Commerce, in its July, 1947 *Survey of Current Business*, deducted $4,689 million as an "inventory valuation adjustment" in determining corporate profits for 1946. This represented almost 40 per cent of the amount shown for profits after taxes. The Department's February, 1948 *Survey* dealt with 1947 profits, estimated as to the last quarter of the year. It stated: "In judging the level of profits in the context of the general economic situation, the data must be interpreted carefully. In the first place, the figure of $29 billion (before taxes) includes $6 billion which reflects higher unit costs of inventories. Had corporations charged the same sales prices, but had it been the universal practice to charge to expense the amounts needed to replace the physical volume of inventories used up in production rather than their money value, corporate profits would have been $6 billion lower. This latter total of $23 billion is the figure reflected by the item 'corporate profits and inventory valuation adjustment' in Table 1." The Department of Commerce is doing something about it.

The New York Stock Exchange, also, is giving serious attention to the problem. In an article published recently, John Haskell, Vice-President of the Exchange, refers to the "illusory phases" of current corporation profits and states that, "by and large, it appears that the total profits of all American companies for 1947 would be just about half of the amount reported on a monetary dollar basis, if correction were made to eliminate the distortions caused by increased price levels in inventory and depreciation figures. There is a pressing need for a generally accepted accounting method of dealing with the problem of reporting earnings in dollars of varying value. In the meantime current company earning reports should be carefully appraised to allow for the illusory profits caused by the violent rise in price levels in recent years." Through Mr. Haskell, the Exchange has formally offered the accounting profession its cooperation and assistance in seeking a solution.

The general subject of profits and the illusory nature of currently reported earnings has also received considerable notice in the press. Editorial comments, some of them quite critical in tone, have appeared in many of the leading metropolitan papers, with even more discussion in the financial press. Technical, economic and accounting magazines have been full of it. You are doubtless familiar with the writings in our United States publications; other discussions have appeared in Great Britain, Canada and Australia. The authoritative and responsible British weekly, *The Accountant*, commented editorially under date of March 27, 1948: "The first question that arises is what is the legal position under the Companies Act—could it be held that a profit and loss account, which did not provide for an estimated increase in the cost of replacement of assets would not 'give a true and fair view of the profit and loss of the company for the financial year'? This is a matter of law upon which, no doubt, legal advice will be taken." The editorial refers to the earlier decision of the Council of the British Institute that provision for increase in cost of replacement is a matter of financial policy, and comments upon more recent differences of opinion on the subject. It concludes with a statement that the matter would "seem to merit the careful reconsideration of the profession so that an agreed principle may be established."

Finally, let us turn for a moment to comments in published annual reports to stockholders. In reading these, one cannot but be struck by the frequency with which the subject of depreciation and replacement is dealt with, and the prominence often given to it in presidents' reports. The president of one major company devoted half of his entire letter to it. Most of the discussion centers around the financial problems involved in replacement of plant, and the need to retain profits. In some cases, there is comment, occasionally critical, on the failure of accounting methods to reflect this. One president stated in effect that, if the costs of construction declined, the money spent in 1947 would result in a loss; if they did not decline, the charges against income for depreciation were inadequate; and that in either event a reserve was necessary.

What To Do About It?

The challenge to the accounting profession from these many sources cannot be waved aside. We are left with the question of how to meet it. There is wide divergence of opinion on this point, not only among practicing certified public accountants but also among controllers and other responsible financial executives. The Committee on Accounting Procedure of the American Institute of Accountants has had the question under intensive consideration, but has reached no conclusion. Accordingly, any comments which I make on this point should be considered solely as my own personal views.

Personally, I think we are faced with a very important and far-reaching problem. One of our basic assumptions, the reasonable stability of the monetary unit, has failed us. We are at a crossroad. We may conclude that we will best attain our objective of making accounting statements useful by continuing straight along the same road, despite opposition and road-blocks in the way. We may decide that the perils of a change of course are greater than any advantages to be claimed for it. But, as accountants, we cannot just stand aside and say there is no decision to be made.

Various roads are open. Economic adjustments following World War I resulted in the appraisal write-ups of the 1920's and the write-downs of the 1930's. This solution brought as many new problems as it solved, and its imperfections have led most of us who went through those eras to say "Never again!" With this experience, some accountants would prefer to continue to reflect monetary profits and believe that changes in the purchasing power of the dollar are not sufficiently material or significant to warrant any major change. They believe that the imperfections of any method which attempts to isolate the effect of such changes outweigh whatever advantages it offers.

Another group suggests that the formal statements should continue, as heretofore, to reflect monetary income, but that they be accompanied by supplementary data which will enable the reader to make his own adjustments, such supplementary data to be separate and apart from the formal financial statements and not covered by the accountants' report. This is not a desirable solution. If the statements need to be supplemented and interpreted, accountants should share the task of doing it. Otherwise, it would be taken as an admission of weakness and would reduce confidence, not only in the formal financial statements, but in the accountants who report on them.

Other accountants think that statements which reflect monetary income alone are inadequate and that where the discrepancy from real earning power is material and significant it should receive positive treatment. One suggestion is that there be an extension of the quasi-, or informal, reorganization procedure under which a corporation would, in effect, make a fresh start with revised figures for plant and inventories on which future income charges would be based, without, however, any requirement for freezing or capitalizing the earned surplus. The difficulty with this is that it would permanently freeze the present level of prices into the accounts without any assurance that the level will remain constant. It is doubtful whether such a solution would be acceptable to businessmen.

Another proposal is the adoption, with respect to depreciation of plant and equipment, of something akin to what has been done by the use of the *lifo* method for cost of sales. The method can be clarified by using a company producing crude oil as an illustration. Let us suppose the company spent $5,000,000 in drilling in 1947 and brought in new wells which increased its developed reserves by 10 million barrels, or at an over-all cost of 50 cent a barrel. If the company had also produced and sold 10 million barrels in 1947, the $5,000,000 spent in that year would be the charge for depreciation or depletion of oil wells. If more oil were sold, the excess would be charged out on the basis of 1946 costs. If less oil were sold, 50 cents a barrel would be charged out, and the difference carried forward as an asset. In either event, only the increase or decrease in developed reserves, i.e., productive capacity, would affect the cost of wells carried forward.

An objection raised to this method is that it could not be applied generally, because plant and equipment and production therefrom are rarely homogeneous in character, and are rarely replaced by like items. There are difficulties in the way of general application, but the idea has its attractiveness. What investors are interested in, and what a healthy economy requires, is not that the identical plant be replaced, but that productive capacity, and consequently earning power, be maintained. Unless this is done, wealth has declined.

Approval, for tax purposes, of the use of index numbers in the application of *lifo* to the widely varied inventories of retail stores points to one further suggestion which perhaps opens up the best prospect of a useful and workable solution. It is that depreciation charges based on original cost be converted to current dollars by means of a formula. Price index numbers would be established for each year on the basis of a norm, say 1939 or some other year or period of years. Plant and equipment would be analyzed according to the years in which the expenditures were made, going back a sufficient number of years to account for at least the bulk of the assets. The relative index figures would be used to convert the depreciation charges in respect of each year's expenditures into terms of the current year's dollar. Except for the establishment of reasonably reliable index figures, no difficult accounting or mathematical task is involved. While index figures vary among themselves, they have roughly the same general and relative trend. The plan has been worked out for a few companies experimentally, using various index figures, such as cost of living, wholesale commodities prices, construction costs, etc., and an average of several of them. The results vary within a reasonably narrow range, and even the extreme limits are not too far apart. With further refinement the result undoubtedly could be improved; and even an imperfect tool is better than no tool at all.

Personally, I would not regard such a method as a departure from the cost basis. To my mind it would merely be the measurement in current dollars of the dollars expended at a time when they would purchase more. It is the dollars themselves that have changed, not the costs. Further, it must be remembered that the rival claims of cost and value as the basis of accounting were long debated. It is clear that statements which showed value, if they could be accurately prepared, would be quite useful. Historically, the value basis has much support, but the increased size and complexity of business, and the impracticability of annual appraisals led to its abandonment. The acceptance of cost as the more useful basis for accounting purposes is based on practical, rather than theoretical, grounds. It provides an objective basis for measurement and minimizes the need for subjective opinion. The same merits can be claimed for the index method.

The concept of a dollar of shifting purchasing power is not a new one, but it is one that may have to receive increased attention. An article by Professor Sumner H. Slichter of Harvard University, in the *New York Times Magazine* of May 16, 1948, makes quite an interesting point. He thinks that in view of the increased strength of trade unions, wages in the future are likely to increase faster than output per man hour, and that this will force a slow but continued increase in the price level. He points to the adverse effect of this on savings invested in money assets, and states that if the decision as a matter of government policy is to accept rising prices, rather than interfere with collective bargaining, "pensions and life insurance will have to be adapted to this fact, and the Government and corporations will have to issue bonds payable in purchasing power rather than a fixed number of dollars."

Related Problems

Should it be decided that the index-number method or some variant of it offers an acceptable solution, questions involved in its application immediately arise. First, should it be applied to the asset accounts as well as to certain figures in income statements? And if not, how should any adjustment be reflected? Second, should it be regarded as a permissive method or mandatory for all cases?

As to the first question, if the reasoning supporting the method is valid, there is no doubt that it would be theoretically sound to go all the way. This would lead us along the road of stabilized accounting, so called, I believe, after a book of that title by Henry W. Sweeney published in 1936. It would also lead us along the road adopted in Germany, France, and Italy, following revaluation of their currencies. I do not think we need to go as far as that. For one thing, balance sheet figures would move up and down with the current index, and this could easily lead to misconception and even distrust. I would prefer, at least for the present, to see use of the method limited to the income statement, and to the objective of showing revenues and costs in units of equal value. The balance sheet could continue to be regarded primarily as an historical accounting for management's stewardship of the stockholders' investment. However, there might well be shown parenthetically on it the current dollar equivalent of *lifo* inventories (or their current market or replacement cost); and also the pertinent figures on which depreciation was being calculated,[4] i.e., the cost of the plant measured in current dollars. The increased provisions accumulated for depreciation and any other adjust-

[4] Compare 1936 report of special committee on inventories referred to in footnote 3. Calling attention to lack of uniformity as between companies in the oil industry which might result from the adoption of the lifo method, the report continues:

"It may be suggested that during the period of development of this method within the industry, any misunderstanding of this kind would be obviated by a parenthetical disclosure in the balance-sheet of the current replacement value of the inventory, whether such value was greater or less than the stated inventory value." (*Journal of Accountancy*, August, 1936, p. 130.)

ments could be included as a special item in the equity capital section. To an extent, at least, they would help to maintain the real value behind the dollars which were originally paid in as capital.

The second question was whether adjustment should be regarded as permissive or mandatory. Obviously, neither the accounting profession nor business itself has legislative powers. If the idea has merit and should receive public acceptance, public opinion and the demand for informative reporting would gradually bring about its adoption. In the meantime, it would be clear which companies adopted it and which did not, and the extent of disclosure by the latter would undoubtedly be extended to meet improved standards of reporting. The problem is one of varying intensity with different businesses, depending on the relative importance of the depreciation charge. Whether it is worth while trying to convert grapefruit into oranges depends to some extent on how many grapefruit there are. Those with only one or two grapefruit might well decide to wait and see whether an accepted yardstick is found.

Uniformity may be a desirable objective but insistence on uniformity at the outset will tend to restrict progress. Some people like a Ford car; some prefer a Lincoln. The *lifo* method for inventories is not used uniformly; only as a permissive method has it attained its present status. Even with its semi-legislative powers, the Securities and Exchange Commission has not considered it necessary in its accounting regulations for investment trusts to insist upon uniformity. It permits two alternative methods for showing investments, their principal asset: either cost, with value shown parenthetically; or value, with cost shown parenthetically.

On the other hand, it is well to remember that one of the most valuable uses of income statements is to compare results and progress as between companies in the same industry, and, thereby, judge the effectiveness of management; and, also, as between different industries. Ready comparability is thus a major objective of income statements if they are to be as useful as possible. Comparability has undoubtedly been reduced in recent years by the adoption of the *lifo* method for inventories by some companies but not by others. It would be reduced further if some companies should adjust their depreciation charges while others do not. To afford ready means of comparison, it thus seems important for adjustments of this nature to be disclosed clearly by companies making them. There is much to be said for a form of statement which first brings down the income on the basis of historical money costs and then shows the adjustments which have resulted from the adoption of an alternative, but fundamentally different, accounting policy which is not universally adopted. This is as desirable in the case of the *lifo* method for inventories as it is in the case of adjustment of depreciation charges. Such treatment would make it abundantly clear what policies had been adopted and what their effect was. It would tend to accelerate uniformity of practice.

Summary

The point of view I have presented can be summarized as follows:

1. Conventional accounting reflects money income but, when prices have changed rapidly, it may fail by a substantial margin to reflect economic income, because some of the costs are measured in current dollars while other costs are measured in dollars of a different time, and, therefore, of considerably different value.

2. Accounting has partially recognized this by approving the *lifo* method for inventories, but has approved no corresponding adjustment for depreciation of plant and equipment.

3. Such an adjustment is desirable in income statements if they are to be as useful as possible, but it should be made by some method which is subject to objective measurement—not arbitrary.

4. The use of an index method to convert past plant expenditure and the resulting depreciation charges to current dollars meets this test and is the most practicable and simple method yet suggested.

5. Uniformity may be desirable, but insistence on uniformity should not be allowed to hamper progress. In order to provide ready comparability of results reported by different companies, it is desirable, however, that the effects of the *lifo* and *fifo* inventory methods and of alternative depreciation methods be isolated and shown clearly in the financial statements.

Conclusion

Accounting Research Bulletin No. 1 contains this statement:

> The committee regards corporation accounting as one phase of the working of the corporate organization of business, which in turn it views as a machinery created by the people in the belief that, broadly speaking, it will serve a useful social purpose. The test of the corporate system and of the special phase of it represented by corporate accounting ultimately lies in the results which are produced. These results must be judged from the standpoint of society as a whole—not from that of any one group of interested parties.
>
> The uses to which the corporate system is put and the controls to which it is subject change from time to time, and all parts of the machinery must be adapted to meet such changes as they occur.

The problems created by rising prices are important from an accounting standpoint, but there are other phases even more far-reaching. Accounting emphasis on historical costs has had economic and social effects of major importance. To return to our shoe merchant, if he was on the *lifo* basis he would be more reluctant to stock up on \$8.00 shoes in a period of rising prices, unless he felt he could turn them over at a profit. If he could not sell them, they would be carried at $5.00, and he would not want to show the loss. Conversely, in a falling market, he might be encouraged to cut his prices and make sales, if replacement cost would give him a profit. Regardless of how desirable a transaction may be, there is a strong psychological reluctance to enter into it if it will show a loss.

The depression of the early 1930's was deepened by an unwillingness to reflect the inventory losses which would have to be taken under the historical cost method if prices were drastically reduced. When prices decline, to avoid showing the loss, we put off selling at prices sufficiently low to create demand; and we put off buying for lack of markets. When we can get most for our money we stop spending it, and not solely because we cannot spare it. If in accounting for inventories and depreciation we could approach more closely the economic view of income as what is left over from revenues after providing for replacement of goods and services consumed, we would change these physiological factors. Encouragement to maintain or increase inventories would be lessened when prices are advancing. There would be encouragement to produce and sell at lower prices when cost of replacement falls. This could not fail to have an effect in stabilizing employment; peaks and valleys of profits would be less sharp. Government revenues would be stabilized too.

An adjustment, at the present time, of the accounting part of the business machine to meet changed conditions can, I think, be supported by sound accounting and economic theory. Even more can it be justified as serving a useful social purpose.

THIRD SESSION

FRIDAY, MAY 21, 1948—2:30 P. M.

Hagerty Hall Auditorium

Chairman:

ERIC A. CAMMAN, *Partner, Peat, Marwick, Mitchell & Co., New York*

Address: "Presenting the Facts on Company Operations to the Employees"

STEPHEN A. DERRY, *Consulting Management Engineer, Louisville, Kentucky*

Address: "The Role of Accounting in Industrial Relations"

PAUL P. COGGINS, *Supervising Personnel Methods Accountant, American Telephone & Telegraph Co., New York*

PRESENTING THE FACTS ON COMPANY OPERATIONS TO THE EMPLOYEES

By Stephen Arthur Derry
Consulting Management Engineer, Louisville, Kentucky

Company operation reports, like companies, have changed with the times. Perhaps the greatest change is the simplification of the reports for use by labor. In preparing reports for employees, some companies make the mistake of thinking that anything in very simple terms will do.

Today, labor analyzes company reports more keenly than the investors. Unions have high paid analysts on their staffs, whose jobs are to analyze company operating reports for their members.

Because of this and other factors, management must consider very carefully the labor reaction in any report it issues to its employees, stockholders or to the public.

In all my dealings with labor and management, I have found that in almost every instance the source of the differences in opinions was traceable to a report that the company had issued to either its stockholders, employees, or the public.

The conventional dry-as-dust figures in financial statements are as complex to the average employee as the text of a doctor's prescription would be to most of you. The conventional form and terminology of financial reports are as misinterpreted by the average employee as the form and terminology of a brief prepared by an attorney would be misinterpreted by some of you. This experience has led me to but one conclusion; that is, company reports no longer can be considered as an esoteric matter. This fact is very clearly demonstrated when one peruses company reports.

First Conventional Report

The first conventional annual report appears to have been issued in 1858 by the Borden Company. In 1942 (84 years later), the format was humanized. The report talked chattily about Elsie, Borden's philosophical cow. Much was mentioned about taxes and vitamin research. However, the attitude of most companies, in the days of the first Borden report, is clearly demonstrated in a statement issued by the New York Stock Exchange in 1866 which in part reads as follows: "The New York Stock Exchange made no reports, and published no statements, and has not done anything of the kind for the last five years . . . " But 29 years later, in 1895, the New York Stock Exchange endorsed the practice of making annual reports, and in 1900 requested companies applying for listings to publish annual reports.

During the eighties, the Interstate Commerce Commission made it compulsory for the railroads to publish annual reports. These reports were complete and highly detailed, but were, in many instances, set up like timetables and were not only difficult to understand but very hard to read.

The reports seemed to be merely reprints of large portions of the data periodically sent to the I.C.C. by harassed secretaries. The compilation of a variety of information about the railroad business seemed to follow no logical sequence.

Some railroads like the C. & O. have modernized their reports, using maps, pictures, and lyrical prose to describe their operations. However, as late as 1942, the Union Pacific report contained such uninteresting information as: "The company constructed two riveted truss spans replacing lattice truss and spans and remodeled abutments and pier in one bridge and constructed steel approach span on concrete abutments and steel bent replacing stone abutments. . . . "

First Modern Report

The U. S. Steel report to stockholders issued in 1902 appears to be the first modern report. This report, prepared by Judge Elbert H. Gary, contained 64 pages, plus a large map. Forty pages were devoted to very detailed financial information, and 24 pages were filled with photographs showing views of representative properties owned by the Steel Company. The report revealed operating facts that heretofore no company dared to reveal. The facts were so profusely illustrated that the directors were practically scandalized. In 1939, U. S. Steel reverted to Judge Gary's presentation, amplifying simplicity. The 1942 report very informally told the story U. S. Steel played in the war; it also explained the expansion program and relations with labor. U. S. Steel's 1947 report covers 36 subject headings, including such subjects as more and better facilities, distribution of steel, labor-management relations, community relations, peace and production, operating and financial facts from 1902 to 1947, inclusive.

The April, 1948 issue of the employees' magazine, *Steel News*, very vividly portrays the company operations under such headings as "Your Score in 1947." The theme of this editorial truly rings a bell with the employees, because it makes the employee feel that his job with U. S. Steel is no different than if he were in business for himself. The editor tabulates the company's financial transactions in such a way as to cause the employee to feel that he is the proprietor of his own shop. For example, considering the average U. S. Steel employee as being in business for himself, the average weekly financial transaction would be as follows:

TAKEN IN FROM SALES TO CUSTOMERS.....		$145.10
PAID OUT FOR:		
Materials necessary for operation........	$57.55	
Wear of machinery and tools...........	6.00	
Machinery replacement cost............	1.80	
Taxes on plant	9.31	
Use of stockholders' money............	4.84	
More and better facilities	3.84	
Social security taxes and pension........	2.12	

Deducting total paid out ($85.46) from total taken in, netted him a sum of $59.64 for his time and efforts. This money was his for groceries, clothes, recreation for himself and family.

The magazine also published a personal letter written by Mr. B. F. Fairless, President of U. S. Steel. This letter portrayed the 1947 operations facts in vivid language. The facts were presented convincingly and in such style to make the employee feel that the making of steel was his business. He told the employees that the plant, in 1947, operated 96.7 per cent of capacity. The plant produced 28.6 million tons of steel ingots and castings.

The company received more than $2 billion for its products and the profit was $127.1 million, or 6 cents per dollar sales.

He told the employees what happened to this profit. He pointed out that $903.6 million or 42.6 per cent of all money received from sales was paid for wages, salaries, social security taxes and pensions. He explained raw material costs which amounted to $841.9 million or 39.6 per cent of the total receipts. He pointed out that the employment and raw material purchases totaled $1,745.5 million, or 82.2 per cent of the total received from customers.

Then he showed what happened to the 17.8 cents left out of each dollar received from customers. He elaborated on the wear and exhaustion costs of each sales dollar. He listed the fact that $136.2 million or 6.4 cents of each dollar of sales was paid for taxes. To approximately 228,000 stockholders, the sum of $70.9 million or 3.3 cents on each sales dollar was paid. The remaining $56.2 million or 2.7 cents out of each sales dollar was used to reinvest into the business of keeping you in business.

Special Reports to Employees

The greatest change in preparing reports came out in 1937. Johns-Manville was one of the first companies to issue a special annual report to employees and has continued this practice every year since. The report was printed in large type, conversationally written, and profusely illustrated. Among the outstanding features of this report was a reproduction of a "Bill-of-Material" form to portray the purchase of raw material. Another was the explanation of the meaning of a balance sheet, which, in effect, explained that a balance sheet was merely a statement of what the company owned, owed, and of what the company was worth. It also explains that the balance sheet had nothing to do with the company sales or income, or with how the money was received each year and divided among employees in wages, and among stockholders in dividends.

The theme of the explanation was that a balance sheet was the same as if you took two sheets of paper and on one you listed the cash you have, the value of your home, car, radio, furniture, clothes, and the five dollars your neighbor owes you. Then on the other sheet, list what you owe the grocer, the milkman, the iceman, the amount you owe for the mortgage on your home, and what you owe the finance company on your car.

Then you subtract what you owe from what you own. The result is what you are worth and what your company calls surplus. This may represent property or cash, or both. This figure you place on the second sheet. Then the first sheet, "What you own," and the second sheet, "What you owe and what you are worth," will balance exactly.

An editorial, "Cloth Woven from Rock," was used in introducing the 1947 report. A sample of cloth made from rock was attached to the page.

The 1937 report had such a profound effect on Johns-Manville officials that, in 1938, the same idea was used for the stockholders' report, and they have been doing it ever since. The 1947 annual stockholders' report contained only 23 pages, but very effectively presented.

Special Techniques

General Foods, in 1940, introduced a new technique by presenting its corporate and operating facts in dialogue at a mythical annual stockholders' meeting. The Board Chairman represented the position of the company, then the various officials answered such questions as: "Please give us more details about our sales!" "What are GF's employee policies?" "Tell us about the inventory position." "I'd like to know what independent auditors do for General Foods?" "If there is a member of the firm of auditors present, would he tell us just what procedures they use?" and "On the Balance Sheet, what is meant by 'loans to employees'?"

The Individualized Method

The old simile, "dry as an annual report" passes into oblivion when one reads the 1942 annual report of R. G. le Tourneau Incorporated, Peoria, Illinois. The President of this corporation must be a very religious individual. He begins the report with a quotation from the Bible (Joshua 10:19), "And stay ye not, BUT pursue after your enemies, and smite the hindmost of them; suffer them not to enter into their cities; for the LORD your God hath delivered them into your hand." On the very next page he writes, "I love to build machinery. I love to design it, but I am constantly aware of the fact that it takes skilled men to build this powerful machinery. It takes skilled men to assemble it properly. It takes skilled men to test it thoroughly, and operate it efficiently; and I would like to add that just as the machine needs a man to direct and control it, so man, who is God's mechanical Masterpiece, needs God to direct and control him."

Report with Views on Government

The 1942 report issued by the Diamond Match Company is filled with 100 large fully printed pages, covering the entire field of company lore from taxes, economics, and the future of California to Congress, democracy, and the abundance of blister rust in Diamond's extensive timberland.

Some companies even include their views on government matters. For example, Monsanto Chemical Company's 1942 report frowned on the S.E.C.'s rulings holding that the corporation reports are proxy soliciting material, and if incorrect might subject officials to severe penalty. To this charge Monsanto bravely continued to publish information in its house organ and quarterly reports.

Report with Dollar-per-Man-Hour Breakdown

Monsanto Chemical Company's 1945 annual report introduced a new technique in breaking the income dollar down to "dollar per man hour." The facts were grouped under three headings, namely:

a. "What we took in"
b. "What we paid out"
c. "This left for employees, management, government and stockholders"

Each item, under each heading, was broken down to portray a picture such as this:

Item		*Dollar Per Man Hour*	
TOTAL TAKEN IN		$3.92	
Received from customers	$3.84		
Fees on government contracts	.05		
Other income from investments	.03		
TOTAL PAID OUT		$2.11	
Raw materials	$1.81		
New equipment, etc.	.30		
TOTAL LEFT FOR DISTRIBUTION		$1.81	
Wages and Salaries	$1.02		
Taxes	.58		
Owners of Company for use of money	.15		
TOTAL DISTRIBUTED		$1.75	
BALANCE LEFT			$0.06

This amount was retained in the business for use, such as payment of the plant and buildings, larger inventories, and for payment of wages and salaries in difficult times.

COMIC-STRIP-ART METHOD OF REPORTING FACTS

Joy Manufacturing Company, Pittsburgh, Pennsylvania, introduced a new idea in its 1947 annual report to employees. On the cover page, the cartoonist shows the company coming through the office door labeled "Business Doctor." The opening statement is, "Here I am for my annual check-up, Doc. How do I look?" The report contains 15 pages with one or two cartoons on each page. The cartoon with comic-strip atmosphere and friendly conversational tone portrays the humorous vein of the report, while the printed portions tell the facts. Each item of the usual conventional financial statement is effectively and conclusively stated. Each cartoon tells what happened to the income and what is left. The last page shows the "Doc" bidding the company farewell until next year.

CREATING EMPLOYEE INTEREST IN READING THE ANNUAL REPORT

The Mengel Company, Louisville, Kentucky, presents an interesting story on furnishing facts as to company operations to its employees.

The company, founded in 1877, published its first statement to its employees in 1939. The statement, a one-page leaflet entitled, "Looking Ahead," in addition to announcing a change in top management, stressed customer relations, supplier relations, organization, employee relations, wages, recognition for long service, and a resume of the company's financial obligations to its stockholders and employees. The first annual report was entitled, "Review of 1939 Operations for Employees." This report was in leaflet form containing an explanatory balance sheet, and a statement of operations.

With the 1944 report, management enclosed a card with a few questions thereon, asking the employees and stockholders to express their views and thoughts about the report. Top management was shocked to learn that less than 2 per cent of the employees responded to the survey. The president of the company, who entered the service of the company at the age of 17 as an office boy and 28 years later (1939) was elevated to the top position, was so disappointed that he issued a special statement to the employees. The statement was printed in a leaflet entitled, "Mengel's Pledge to You." The theme of the leaflet was a statement of principles in employee relations, again stressing wages, rates of pay, machine, mechanical process, credit union and retirement plan.

As a result of the employee survey, the 1945 annual report was modernized. This report was made "hard to get." The only way a worker could get a copy of the 1945 report was by asking for it, either in person or in writing. The company was again shocked to learn that employees made little or no attempt to get copies of the report. Other innovations were included in the 1946 report, and management decided to stand at the gate and hand out the reports to workers as they left the plant. The result was still disappointing. The 1947 report was greatly improved with more new ideas and filled with unusual charts, graphs, photographs, and detailed information on company operations. One of the features of this report was the breakdown on "Per Dollar Income." The breakdown showed the distribution in this order:

Distribution:		*Per Income Dollar*
Wages and Salary		39¢
Factory employees	$10,621,100	
Salesmen and Supervisors	2,401,300	
Officers and Directors	227,400	
Benefits	709,000	
Total	$13,958,000	
Raw Materials		48¢
Supplies and Services	$17,109,000	
Depreciation		3¢
Depletion	$ 975,000	
Taxes		4¢
Federal, State and Local	$ 1,489,300	
Dividends		2¢
Stockholders for use of their money	$ 778,800	
Remained in the Business		4¢
Improvement and emergency uses	$ 1,517,400	

Management decided to mail the 1947 annual report. The result was the best the company had obtained in creating employee interest in the annual report of the company operations.

Reports Emphasizing Product and Plant Facilities

The B. F. Avery & Sons Company, Louisville, Kentucky, founded in 1825, put out its first modern annual report in 1944. Its theme was the farmer and his implements. The report was well received by the farmer, because the content was pictorially displayed in such a fashion that the farmer felt proud to have a copy of the report. This report revealed for the first time to many inhabitants of Louisville and Kentucky that Avery manufactured modern power-driven farm machinery. It was through this report that the public knew, for the first time, that Avery could no longer be considered as a small manufacturer of horse-drawn farm equipment.

The 1945 and 1946 Avery reports followed the same theme as 1944, with more emphasis on Avery's products and problems. The theme of the 1947 report stressed new manufacturing facilities and new products. The pages, including the cover, were well balanced with photographs of Avery's tractors, plows, harrows, planters, cultivators, rotary hoes, and several other farm implements in action. Each of these photographs were action pictures demonstrating the practical application of Avery farm equipment. The three middle pages conveyed the financial story. Presentation was conservative but very forcefully portrayed.

I have elaborated on this report because the text was designed to appeal to the farmer. It so happens that many of Avery's employees owned small farms. Thereby, through this appeal the company got across to its employees the importance and uses of the product they help to make.

Reaction to Operation Reports

The officials of the Allegheny Ludlum Steel Corporation, Pittsburgh, Pennsylvania, invited its readers to comment on the company's annual report and company policies. The adverse comments were shocking to company officials. Some of them were: "The United States Government, as big as it is, needs only one Vice-President, how come you have so many." "Be brief and to the point." "Tell the amount earned per common share." "Is it better than the previous year? If not, why? and what can be or is being done about it?" "Just include a little letter or a note, as a father would to a son or daughter, then we would feel that we really belonged." "This survey, to me, seems stupid." "The management should know what its stockholders should know." "I am not a scoffer," said another, "but I think 75 per cent of the subject matter in the average annual report is a waste of time and energy." "It is easy in bad times to omit the stock dividends for the year, but there is never anything said about a cut in the president's salary if he doesn't operate the company at a profit," one said.

These criticisms are worthy of further analysis: The comment "too many Vice-Presidents" reflects a common type of distrust that is a result of misunderstanding. Actually, the company had only one executive vice-president, and only four other vice-presidents. The vice-presidents compare with the secretaries of the President's cabinet. Each vice-president was charged with heading a specific set of activities.

Over 3,000 readers responded to the questionnaire. Of these, 98 per cent said that they read the annual report; 53 per cent said that they do not keep the report for future reference; 61 per cent said that they were not satisfied with the report in its present form; 31 per cent claimed that the report was "somewhat interesting"; 10 per cent attested that the report was clear; and 20 per cent claimed that the report was either too general, too technical, too formal, too dull or too vague.

The questionnaire asked the readers to express their opinions on the company's weekly radio program, "Steel Horizons." More than 65 per cent reported that they had never heard the program.

Information That Appeals to Employees

In most instances, the daily job represents the worker's LIFE CENTER. The worker has HOPES, FEARS, AND PRIDE. When a worker reads a report these emotions are uppermost in his mind. He looks for his part in the manufacturing process. He is interested in knowing the company's progress and stability. He is interested in only those financial figures which reveal to him the relation of his own job and his own prospects. He likes to read about his company in the local newspaper. He likes to hear his company mentioned over the radio. He wants to know how the profit is spent. He is interested in knowing the use, importance and value of the product he helped to make. He is desirous of knowing who owns the company for which he works. He is interested in knowing the history of the company and what prospects the company has in the future. He wants to know if the stockholders live in the community, or several thousand miles away from the plant. He wants to know who they are—bankers, investors, women, radio stars, etc. He would like to know if the stock is available to him. I could list a dozen more subjects that interest the worker, such as comparative wage rates for his job with other companies in the community, what benefits the worker receives that are offered by other companies, etc.

When a worker reads management's report on company operations and fails to formulate his own answers to these items I have indicated, it is only natural to get the unfavorable reactions that some companies have experienced.

Presenting Operation Facts to Employees

In presenting operation facts to employees, the universal prerequisites for all companies may be grouped as follows:

a. Establish a sound personnel philosophy
b. Initiate and support progressive labor policies
c. Execute at all times a genuine desire to deal justly with all employees.

When these policies have been inaugurated by the company, then management of the company is ready to formulate a program which will promote better employee-employer relations, and dispel public misunderstandings about the company.

The basic principle of this program should be employee education. The subjects covered in this educational program should be:

1. Financial
    a. The importance of stockholders
    b. Why reserves are needed
    c. Facts on taxes
    d. Why a profit must be maintained
    e. What is break-even point?
    f. Why break-even point is important
    g. Effect of wages on stability of company
    h. Effect of other matters on financial standing of company
2. Operation
    a. The reasons why controlling expenses are important
    b. The effect wages and raw material costs have on profits
    c. The need for maintaining high productivity per worker
    d. The role that inventories have on the cost of the products
    e. The importance of product wastes and rejects
    f. How volume in manufacturing affects prices, wages and wastes
3. Public Relations
    a. The importance of holding custom's good will and general public patronage
    b. Community interest and activity and its effect on employees
4. Human Relations
    a. The importance of harmony with fellow workers
    b. Its effect on the employee himself, management, production, fellow workers, customers, quality and quantity of product

5. Economics
    a. Wage trends in other competitive industries
    b. Importance of advertising and relation of company operations to the economy in the field the company is operating
    c. The importance of balanced economy from within as well as from without

Putting Employee Education Program into Effect

Perhaps the best way to make this type of program effective would be to start training top management. Employees at this level may fully understand all principles of the company operations, but may not be familiar with the details, and, in some instances, do not know how to present operating facts to employees in a manner interesting to the workers.

Getting Operating Facts Across to Employees

In getting operating facts across to employees, the following is suggested:

First: Information must originate at the top. This information could be disseminated by memoranda at regular intervals. The information should cover over-all company operations, product data, sales, and other current facts involving the company as a whole.

This information then could be used as a guide by those charged with the responsibility of releasing correct information to the public and employees.

Second: Information must be obtained from without, pertaining to trends in products, prices, and public opinion. Also, information must be obtained from within the company on attitudes and opinions of the supervisors and workers. This gives the employee a feeling that he is a part of management.

Once the desires of top management are known and the feeling and thinking of the workers are analyzed, the company's Director of Industrial and Public Relations is ready to start the third step in getting facts across to employees. This step is the actual conveyance of the information directly to the employees.

Ways and Means of Disseminating Company Information to Employees

The usual channels in conveying information to employees may be grouped as follows:

1. *House Organ*—This medium should discuss the worker and his problems in HIS LANGUAGE. The information released through the house organ must be consistent in its character, always personal, always with employee flavor, and,

by all means, newsy and spontaneous. The theme of the house organ at all times should build a feeling of belonging.

2. *Letters or Memoranda*—When matters come up that involve legal implications which affect both company and employees, the letter or memorandum is probably the best medium to use. The communications should be directed to the employee's home and under no circumstances distributed at the plant. In this way, the employee's family is brought into the discussion and usually the employee's family has a stake in the matter, thereby making it desirable to consider the matter in the atmosphere of the home, instead of the surroundings of the work area.

3. *Leaflets*—The primary use of this means of communication is to get messages across to customers and consumers. The theme of these leaflets should be a discussion of the company's viewpoint of some misundertood or misinterpreted facts about the company, or its product, perhaps some popular subject matter of interest to all workers in the community. Many utility companies insert leaflets with their monthly bills to consumers, and some manufacturing companies give leaflets to their salesmen.

4. *Annual Reports.*—This medium has been adequately discussed at the beginning of my talk this afternoon, but, in passing, I might mention that annual reports should be addressed to both stockholders and employees. By doing this it helps to make the employee feel that he is given the same information as is given to the stockholders, and the feeling of being excluded from guarded facts is dispelled. I would also like to mention that it is a mistake for companies to depend wholly on annual reports to get operating facts to employees. The annual report should serve as a summary of actually what took place.

5. *Publicity*—It is a good idea to let the employees in on new products before releasing the information to the press. Nothing makes an employee more distrustful toward his employer than to pick up a trade journal or a newspaper and read about a new product his company has released for sale, or developed of which he knew nothing. Publicity should be given to all worthy achievements of employees. It makes the employee feel that he is appreciated. It strikes deeply into his emotion of pride.

6. *Advertisement*—Perhaps this medium could be best explained by referring to the advertising philosophies used by utility and insurance companies. The next time you read a current magazine such as *Time* or its equivalent, look at these advertisements and note the story they tell about their employees.

7. *Payroll Inserts*—This medium should be limited to those facts pertaining to the employee's pay or conditions affecting his pay. The dissemination of unrelated information in the pay envelope is a gross psychological error. Some companies have made the mistake of inserting such information as, "The president did not receive the $100,000 salary as take home pay reported in the newspaper, because he had to give $60,000 of it for taxes."

8. *Biographies of Brass Hats*—Explaining to the employee how top management personnel was elevated to "Mahogany Row" goes a long way in bringing about a closer feeling from the worker toward top management personnel. A thumbnail sketch of one or more of the top personnel intrigues the worker and removes that mythical idea of some workers that top management personnel are inhuman.

9. *Handbook*—This medium is primarily used for acquainting a new employee with his duties and responsibilities to himself, the company and his fellow workers. Also, the handbook serves as an excellent medium for old employees to keep the general operating policies before them for reference and guide.

10. *Personal Contact*—This medium brings about understanding and feeling in such a way that both the employer and employee benefit. The direct contact with the worker from all levels, up and down, brings about an *esprit de corps* that cannot be accomplished in any other way. The personal contact is one of the best ways to control the oldest communication system known to man—"The Grapevine." Nobody likes a whispering campaign. When the personal contact medium is allowed to drop into the background, the grapevine method of passing information can do more harm than written words can create. The personal contact up and down is very important, not only in the plant or while at work, but at all times.

11. *Film*—This medium combines all the means of communication discussed in my message to you this afternoon. Perhaps the best example of this medium is the sound film produced by the International Harvester Company. The title of this film is "Profits Means Progress for Everyone," which you will see in a few minutes. In reviewing this film, I ask you to observe how this company combined in one medium practically all the things I have discussed with you, plus a lot of things I left out. Notice how the word *progress* is woven with such important words as *customers*, *jobs*, *wages*, *prices*, *production*, *inflation*, *sales*, *stockholders*, *companies*, *food*, *transportation*, *investments*, *plants*, *competition*, *profit*, and *the future*.

Closing Remarks

Before closing, I want to call your attention to the display of annual reports issued by such companies as I have already mentioned, and some that I have not mentioned. On the table to my right, there are complimentary copies of annual reports from several companies, which you may pick up before you leave this afternoon. I want to call your attention to the large chart with all the silver glued to it. This chart was used by management within the last few weeks, as a means to discuss wage-increase demands made by the Union. Also, I ask you to observe the very large portfolio used by one company to fight inflation.

Gentlemen, what I have given you this afternoon is merely a scratch of the surface of what has been done and what can be done in presenting company operating facts to employees.

Thank you, gentlemen. It has been a real pleasure to be with you this afternoon and I only wish it were my privilege to become better acquainted with each and every one of you.

The sound film, which will now be shown, will continue about 26 minutes.

THE ROLE OF ACCOUNTING IN INDUSTRIAL RELATIONS

By PAUL P. COGGINS
Supervising Personnel Methods Accountant,
American Telephone and Telegraph Company, New York City

The subject of this session, "Use of Accounting Data by the Industrial Relations Executive," is one which seems agreed to be particularly significant and timely. I have listened with interest and profit to the presentations of previous speakers. Mr. Derry's talk on "Presenting the Facts on Company Operations to the Employees" provides a very helpful setting for my few remarks on "The Role of Accounting in Industrial Relations." In his presentation, as in the film which followed, it was clear that many, if not most, of the basic facts suggested must come from accounting records. In undertaking to prepare for this talk, I have reviewed some of the literature bearing on this subject and was particularly interested in the comprehensive book, *Industrial Organization and Management*, by Professor Ralph Currier Davis of Ohio State University. In this text, originally published in 1928 and revised in 1940, Professor Davis presented some very pertinent background for this subject in his chapters on "Basic Factors in Organization and Operation," "Functions and the Division of Responsibility," "Personnel Research Standards and Control," and "Cost and Budgeting Control." Another significant text, *Personnel Management*, by Michael J. Jucius, Professor of Business Organization, also of Ohio State University, published in 1947, has many timely references to this subject, including the striking statement on p. 653, "No other road will lead to stable labor relations but that which is paved with facts, information and statistics." Many of these paving stones must come from accounting records. You have indeed made important contributions here at Ohio State University in this field, as in many other fields.

In the *Proceedings of the Ninth Annual Institute on Accounting* held here last year, I find also significant references relating to this subject. The paper, "How Accounting Can Help in Running the Business," by the chairman of our present session, Mr. Eric A. Camman, is particularly relevant. His outline of functions, particularly those relating to personnel, served as an excellent starting point for my thinking. In addition, numerous other discussions relating to this subject have appeared in recent issues of the *Controller*, published, as you know, by the Controller's Institute of America. The foregoing references are mentioned, not with any intention of escaping responsibility for this talk, but rather to indicate that the subject, while by no means new, is growing in interest and in importance to accountants, as well as to management in general.

In view of the increasing importance of industrial relations work, it is desirable that accounting people, including the statistical, economic, and actuarial analysts frequently associated with them, keep in touch with it and sense the problems and trends. They should be alert to appropriate opportunities for changing the basic accounting records to facilitate prompt and accurate data being drawn off in the form needed, with the proper interpretations and caution needed to present top management with facts for sound decisions. In addition, industrial relations people should be informed as to the types and relative reliability of data available and useful for their purposes, and as to those studies and research activities which accounting and statistical people may be best equipped to handle on an economical basis.

The industrial relations job in most large companies, and in many smaller ones, is not confined to the top policy-making level and its staff, but significant portions of it are generally found in most, if not all, of the larger departments. In fact, line management at all levels really effectuates industrial relations policies, and to do so most effectively should understand the considerations upon which they are based. With this wide range of possible users for information obtainable from accountants and statisticians, it might appear that what could be done along these lines is almost limitless. However, it is obvious that there must be some practical limits to worth-while participation at any given time. The immediate objective must be to meet the current requirements of top industrial relations executives for information bearing directly on their day-to-day problems. As these day-to-day jobs are done effectively, there will be opportunities for increased participation on the broader objectives of furnishing still more comprehensive information. This should lead toward increased productivity and economy in effort and in time through the more general knowledge of business principles and the possible applications of business facts. It should contribute also to improved understanding between management, employees, and the public. To assume their proper share in this responsibility, accountants should, increasingly, learn to think, talk, and write in the terms most familiar to top management, and thus make progress toward establishing full utilization of the possible contributions of accounting to business administration in general.

As an indication of the broad, fertile fields in which accountants may assist industrial relations executives, the following may be suggestive:

1. Basic Financial Records
2. Employment and Placement
3. Employee Records and Statistics
4. Advancement and Training
5. Absence and Turnover
6. Employee Services
7. Surveys of Wages and Working Conditions
8. Wage and Salary Administration
9. Benefits and Pensions

The foregoing list will, I trust, suggest to you some areas within which studies, undertaken in cooperation with industrial relations people, may lead to results which will prove of value to industrial relations executives. Before discussing more in detail what some such studies might be, it is perhaps worth while to indicate that accounting organizations may be considered to have a dual role with respect to industrial relations work. In addition to being a significant part of the total organization with industrial relations problems and other responsibilities of its own, the accounting organization is in a particularly good position to furnish, either directly or indirectly, from its regular records, much basic information regarding employees. Accounting people should not, however, consider their participation as being completed by the furnishing of such basic data, or the mere summarizations thereof. They can make their greatest contribution by analyses, interpretations and graphic presentations of such basic data, not only for the particular company, but also in the assembling, analysis, and interpretation of relevant, corresponding published information for their industry or for business as a whole, over a significant and properly chosen period of time. It may be possible to go beyond the published information to basic sources where desirable, with appropriate coordination with other company groups to insure both good will and good facts.

With the foregoing rather general observations as to the possible nature and scope of accounting contributions, it may be appropriate to make a few more or less random suggestions under each of the main headings outlined.

Basic Financial Records

In addition to the normal accounting work required for the preparation of the basic financial records of the company, it may be practicable and desirable to maintain such separate accounts or subaccounts as are needed to provide information as to the relationship of payroll to total expense, or to total dollars of sales, investment, etc., not only for the company as a whole but separately for the major administrative groups of the organization as well. From such basic data it is possible to develop significant interdepartmental comparisons and trends which may provide industrial relations people with a worth-while perspective. Further, such figures provide a starting point for more fundamental studies of the effect of wages and wage rates on the costs of production and the net return of the business.

Employment and Placement

As an outgrowth of responsibilities in connection with advance planning, accountants may be in a favorable position to assist in determining departmental needs for employees, both for growth and decrease, allowing for probable losses. They may also be in a position to make or secure analyses of labor conditions in the communities in which they operate, to determine the sources and timing for securing the needed employees. Accountants have some dealings with Government employment agencies in connection with their regular work, which might readily lead to useful information in this field. Statistical studies of the effectiveness of employment interviews and tests may also be a practicable field for accounting assistance to industrial relations executives in their work toward better employment methods.

Employee Records and Statistics

Most accounting organizations, I presume, maintain more-or-less centralized and standardized records concerning individual employees, listing not only the name, age and obvious biographical and education data, but also the positions that have been held and the associated wage rates throughout their career in the company. Along with this basic information, most Accounting Departments process the payrolls from which information concerning earnings, overtime and attendance, as well as basic pay rates, may be obtained. Some companies have found it worth while to maintain a perpetual employee inventory on punched cards which provides for quick sorting and tabulation and analysis of more significant facts concerning employees. From this "census" type of information, many studies of significance to various levels of industrial relations executives may be readily prepared. Examples of such studies might be studies of ratios of supervisory and staff employees to total employees, or the proportion of employees eligible to pensions, vacations, and so on.

In this connection, particularly, a word of caution may perhaps be appropriate on the subject of "misleading averages." There is a natural and proper tendency to boil masses of data into compact over-all figures for management. However, it is a responsibility of the people who furnish such over-all statements to make sure that they are not misleading or actually erroneous. In this connection, I recall a situation some years ago in which average wage rates for a large group of employees were increasing rapidly during a period when practically no changes had been made in individual basic wage rates. This was due to the effect of the changing composition of the force, in which the higher force losses among employees with lower periods of service and lower wage rates occurred, along with the retention of a nucleus of longer-service people at higher wage rates. During the recovery from the situation just noted, the addition of substantial numbers of lower paid new people to the force more than offset real increases in basic wage rates, so that the trend in average wage rates was downward during a period of increasing individual wage rates.

Advancement and Training

From basic employee records, it may be practicable for accountants to assist in tracing the historic channels of advancement and progress through the organization, determining the relative frequency with which various paths have been followed from the lower to the higher levels. This may assist industrial relations people in their researches on desirable modifications in such channels, and in developing training programs suitable to prepare people for progress in the business. Further, in connection with training, accountants may assist in research as to future training requirements and estimates of the probable costs of such training which may be helpful to those responsible for developing broad training programs. It may even be possible to assist in developing some measurements of the benefits resulting from such programs, in terms of increased production, decreased absence and turnover.

Absence and Turnover

Basic over-all data regarding absence may, usually, be made a by-product of payroll procedures, in addition to being available from such other sources as individual employee records. Frequently, some indication is also carried on the payrolls as to the nature and cause of the absence. In some instances, it is true, there may be some question as to the real facts back of the reported information. Many interesting and significant facts, however, can be developed from analysis and summarization of reported information on absence. Studies of absence by days of the week have shown that absence is higher on Mondays and lower on pay days than on the other days of the week. I would not, however, want to leave the impression that any major portion of the absence is, generally, due to malingering. Where practices for the payment for absence vary by length of service, etc., it may be worth while to analyze the absences separately, as between appropriate groups of employees.

Perhaps the accountant's most obvious contribution to the subject of turnover would be an attempt to measure its cost. This is frequently, however, quite difficult, and it might be better to start with the measurement of its extent. There are a large number of formulas and approaches to measuring turnover. Without going into a discussion of the relative merits of these, it is probably satisfactory to adopt some fairly simple and common formula, applicable to the record system in effect, and then to maintain and furnish comparisons and trends for appropriate groups inside and outside of the company. It has also been found worth while to distinguish between voluntary and involuntary separations, and to analyze each by occupation, age, sex and term of service of the employees in the business. From such analyses, it may be possible to help industrial relations people identify potential trouble situations and suggest appropriate action before they develop into industrial relations headaches. While not particularly an accounting function, it is perhaps appropriate to mention at this point the possibility of undertaking to assist in making analyses of the causes for losses by means of termination interviews, questionnaires, etc. Both absence and turnover may be considered, in part at least, as reflections or measures of morale, and, as such, may have more than their obvious significance.

Employee Services

Here again, the accountant's most obvious contribution to the analysis of employee services, such as medical services, social activities, voluntary payroll deductions for savings, insurance, etc., is in the determination of the associated costs, and the extent of participation. Following naturally, but much more difficult to carry out, is the evaluation of the returns from such expenditures. However, it may be possible, through suitable correlations between the extent and timing of these activities and lowered absence and turnover rates, to provide some rough indications of their effectiveness.

Surveys of Wages and Working Conditions

In these days, even more than before, the relationship of company wages to outside wages in the same community, industry, or in business in general in the locality is of particular significance to industrial relations executives. While it may be worth while for some companies and industries to undertake to make and summarize their own surveys, there are an increasing number of published surveys in recent years. Some of the better known are conducted by the Bureau of Labor Statistics, National Industrial Conference Board, and the National Office Management Association. In addition, there is an increasing number of cooperative local surveys. It would seem worth while for accountants to be familiar with such sources, to know their scope and particularly their limitations, and to present appropriate analyses and thorough interpretations to industrial relations people.

In addition to surveys of wages, it is only slightly less important to be familiar with the associated working practices and conditions, such as hours, benefit and pension practices, etc.

Another subject of interest is the various published and unpublished studies on costs of living. Statistical analyses of these are also of potential interest and value to industrial relations people.

Wage and Salary Administration

This is a field in which it is particularly important that industrial relations executives be as completely and currently informed as possible. From basic employee and payroll records, many data and summaries can be furnished industrial relations people to assist in salary and wage administration. Charts of typical wage and salary progression may be developed separately for significant employee groups, such as management and non-management, staff and line, by organization levels, etc. Also, here again, comparisons between comparable jobs may bring out facts deserving of industrial relations attention. In such analyses, particular care must be taken not to rely too much on comparable titles as indicating comparable responsibilities. Analyses of the actual functions and responsibilities beyond the title should be made, appropriately coordinated between interested groups, and utilized before wage classifications and comparisons can be fully significant and satisfactory.

Benefits and Pensions

This is a particularly fertile field for accounting participation. The introduction of benefit and pension plans requires various studies in connection with their initial and estimated continuing costs. Analyses of costs of sickness-and-accident-benefit plans already in effect provide the basis for analyzing changes being considered by the industrial relations people. Where more liberal plans are contemplated for certain age and term-of-service groups of employees, estimates of cost would, of course, take the relative numbers in these groups into account as well as the probable effect on the incidence and duration of absence resulting from the practice of paying for it or not paying for it. Actuarial and accounting calculations, which it is inappropriate to discuss here, are involved in the determination of benefits and pensions.

Summary

In conclusion, these rather rambling remarks are intended to point out that accounting management has other important possible functions in addition to its long-accepted role of providing basic reports as to the financial results of the company's operations. Accountants are in a special position to assist the industrial relations executives by:

1. Preparing prompt, accurate and significant facts about their company
2. Assembling pertinent facts about the industry and business in general
3. Developing appropriate measurements of productivity, quality and other more-or-less intangible but significant elements of the business
4. Analyzing, correlating and interpreting all these facts.
5. Presenting them to management in a clear, graphic form which will bring out the most essential facts and their interrelationships sharply and objectively, so as to minimize possibilities for misunderstanding.

This is a large order, but I feel certain that the accounting profession is equal to such a challenge.

FOURTH SESSION

FRIDAY, MAY 21, 1948—7:00 P. M.

DINNER SESSION

Deshler-Wallick Hotel

Chairman:

WALTER C. WEIDLER, *Dean, College of Commerce and Administration, The Ohio State University*

Introduction of honored guests

Responses

Address: "Industry Reports to the Consumer on Prices, Costs, and Profits"

C. E. JARCHOW, *President, Controllers Institute of America, New York City*

INDUSTRY REPORTS TO THE CONSUMER ON PRICES, COSTS, AND PROFITS

By C. E. Jarchow

President, Controllers Institute of America, New York City

In the morning and afternoon sessions of this conference you have considered the use of accounting data for investors, for industrial relations executives, and for employees. Tonight's subject on "Industry Reports to Consumers" seems to round out the presentation. There is, of course, considerable interrelationship between all of the groups considered today. Some consumers are stockholders; some consumers are employees; many employees are stockholders. Moreover, when industry makes reports to consumers, it is in effect making them to the general public as well.

For discussion of my subject, I have divided it into the following three categories:

1. Why industry should do its utmost to report effectively to consumers with respect to prices, costs, and profits.
2. What should be reported by industry to consumers with respect to prices, costs, and profits, and how this can best be done.
3. Some examples of industry practices and reports as affecting consumers.

Why Industry Should Do Its Utmost to Report Effectively to Consumers with Respect to Prices, Costs, and Profits

There are, of course, many reasons why consumers should know more about the policies of industry with respect to prices. In fact, there would be a better appreciation of the whole system of free enterprise if they had an understanding of fundamental economics, of the part that industry plays in the economic picture, of the practices which contribute to economic growth and progress, and the practices which are not in the economic interest of the public.

Several years ago a study was made by the Opinion Research Corporation regarding the beliefs of the public as to earnings of corporations. It revealed a general feeling on the part of the public that the earnings of corporations were three and four times greater than the average actual earnings which prevailed at that time. There was a common belief that the owners of the business took approximately 75 per cent of the amounts that were available after payments for materials, operating expense, etc., and that employees received only about 25 per cent. Actually, the situation with respect to most companies was substantially the reverse, owners receiving 10 per cent to 25 per cent of the amounts available and the balance going to employees. The question was asked as to what was regarded as reasonable profits by corporations. The answers to this indicated that, on the average, the public's conception was that reasonable profits were nearly double those actually earned by corporations. There was also a common belief that any profits which ran into millions of dollars must necessarily have been excessive. One would naturally suppose that such a question could not be answered without first inquiring what these profits might be in relation to the capital investment.

This study did much to bring industry to a realization of two facts: first, that an inadequate job has been done by industry in telling the public how business operates and what the results of operations have been; and second, that future reports of industry might very well emphasize this phase of the business story which is so generally misunderstood, in the hope that these popular misconceptions may be corrected.

Management in comparatively recent years has begun to appreciate the importance of this, especially when it realized the general ignorance on this subject of people who are otherwise well informed. Many of the larger companies have established public relations departments, and much has been learned in improving the techniques for carrying on good public relations.

It should be pointed out that there is a fundamental difference between public relations and propaganda. Public relations has for its objective releasing information regarding business decisions which may affect the public directly or indirectly, and also making known the reasons for such decisions. It should not be for the purpose of trying to sell the public ideas which have only a selfish purpose. Management frequently makes important decisions without adequately informing the public. Such decisions sometimes draw criticism, which might have been avoided if the public had been familiar with the reasons for the action taken. It is far easier to explain a business decision in advance than to answer a criticism after such decision has been made effective.

There has been an increasing trend toward more disclosure of facts by corporations. As an example of this trend, it is interesting to go back for about 20 years and compare the annual reports of those days with the annual reports which are available now. It is apparent that years ago the annual reports gave a minimum of information to the stockholders regarding the results of operations, the financial position of the company, and the plans for the future. In those days there was a feeling that it was dangerous to release too much information. Today the average corporate report is much more complete. It takes the stockholders and the public into management's confidence regarding the problems facing the business and the plans for meeting these problems, and presents in considerable detail the results of operations and the general outlook, as well as many other matters.

What Should Be Reported by Industry to Consumers with Respect to Prices, Costs, and Profits, and How This Can Best Be Done

It is, unfortunately, a fact that many reports issued by industry are read by only a fraction of the groups for whom they are intended. As an example of this inherent difficulty in reporting, let us consider again the annual reports to stockholders. It is regrettably true that although the annual reports of today are more attractively designed than previously, and despite the fact, as we have indicated, that they contain much more information than heretofore, there are relatively few stockholders who take the time to read them carefully. This is why many companies show on the first page of the report the pertinent data regarding the results of operations for the current year and the previous year, the financial position of the company, and other basic statistics. This is done with the expectation that if the stockholders will at least read this first page, they will be in possession of the more essential information regarding the company.

While the number of stockholders who read their annual reports thoroughly is disappointingly small, the situation with respect to consumers is even worse. It obviously cannot be expected that many consumers will carefully study the various annual and interim reports of the companies from whom they buy products. Neither can they be expected to make a conscientious effort to determine the reasonableness of prices they pay for these products. Consumers do not actively seek information from industry. Moreover, consumers cannot be forced to read or to believe the information which industry turns out.

It is a truism that no kind of reporting can convince the potential reader of anything unless it first attracts his attention and then stimulates his interest. It is difficult to accomplish this unless he already has a definite and particular interest in the subject. This immediately suggests that there are two realms or fields for reporting, the first of which pertains to facts in which the intended recipient, as the consumer, already has an active and immediate interest. It is comparatively easy for industry to report effectively in this field because it is specific and because the consumer wants to know—he is receptive and can readily understand such information. Then there is a second field of information with respect to prices, costs, and profits that fundamentally is more basically significant than the first, but which, because it possesses certain general and technical aspects, is extremely difficult to present understandably, interestingly, and therefore, effectively. The average consumer will not readily comprehend or appreciate this kind of information, and generally refuses to identify his active and immediate interests therewith. This makes industry's reporting job in this field a formidable one, but industry must continue to strive therein for the highest possible degree of accomplishment because of the far-reaching and fundamental nature of the facts involved.

Let us now delineate the boundaries of these two informational fields and consider how reporting with respect to each may most effectively be done. First, in considering the field in which consumers are already actively interested, it is pertinent to contemplate some of the characteristic attitudes of consumers. Such attitudes are basically simple, natural, and very human.

Certainly, a normal consumer is always hoping to buy at bargain prices. He seeks to obtain the best quality of product or the best kind of service at the lowest price. He likes to feel that his money has been spent wisely and that he has obtained sound values. He resents the feeling that the seller is charging too much or that other consumers are able to buy more intelligently than he. Because of this attitude it is a rather common occurrence for him to complain that prices are too high. He is prone to believe rumors of exorbitant prices and unreasonable profits, particularly with respect to the products that he wishes to buy. This is especially true of products which have not changed in design or utility over the years. When he buys something which is newly designed or which represents a definite improvement over what was previously available, he is not so inclined to question the price. He is also more critical of prices of articles of necessity or those required for daily use than of articles for display or of a luxury nature.

Characterized by such basic ideas and attitudes, what are the phases of a company's business in which a consumer is most likely to be interested and to the reporting of which he will be most apt to respond? I believe it is generally true that consumers like to feel that they are buying the products of a progressive company which is alert to the trends of the times and keeps its products up to date, and which makes good services available to its customers. Consumers are also interested in the availability of the products they are seeking. This has been particularly true in recent years of shortages and pent-up demands. Therefore, when production is interrupted by wage disputes or by shortages of critical materials, and if this occurs when deliveries are already badly delayed, consumers are interested as to when these products will again be available. They are also interested in new products which are to be released in the future, but if the announcements are made too far in advance and if the promises are not fulfilled, they may be bitterly disappointed. In this respect, it is generally true that products which make work easier or provide more comfort are always of interest. It is also a common reaction on the part of most consumers that if they believe that a company has satisfied employees who take pride in their jobs and in the products they help to build, and if they believe that the company is well thought of in the community in which it operates, they will feel more kindly toward its management, more favorable to the company, and will be more satisfied customers.

Consumers are always interested in price changes. When prices are adjusted upward, this should be made known immediately to distributors and to the public generally, setting out the reasons for the increase in prices and the reasonableness thereof in relation to other factors. Companies sometimes make substantial increases in prices without any advance notice. It then becomes too late to make a satisfactory explanation in answer to criticisms as to why the increase was necessary. Under such circumstances, there is a strong suspicion that the increase was not fully justified and that the company hoped to get by without undue public notice. Moreover, consumers are suspicious of general price increases, particularly those which represent a flat percentage of increase on all products. Price increases which vary in percentage and which obviously are related to cost increases on a selective basis are more acceptable. In such situations where it is feasible to avoid increases on certain products, it indicates to the consumer that management exercised a certain degree of restraint and attempted to apply the increases where they were most needed. Best of all, of course, is a situation where an announcement of price adjustments includes some examples of no increases and some examples of price decreases. A statement of that kind is generally accepted as a demonstration of good faith and an attempt to follow sound pricing policies.

There exists in many fields today gray or black markets of certain products which are critically short in supply. The existence of such markets generally demonstrates that manufacturers or regular distributors are voluntarily refraining from advancing prices as high as the market will bear.

This, of course, is commendable, and industry has a right to take credit for it. Consumers are naturally concerned about gray or black markets and are sometimes suspicious of the reasons for their existence. They are interested in learning from industry all of the facts regarding it, what industry's relationship might be toward it, and what is being done to combat it.

Let us now consider some of the ways by which information can be conveyed by industry to consumers and to the public on these subjects in which they are already actively interested. These would include:

1. Press releases regarding specific company developments.
2. Institutional advertisements designed to present the company's point of view on some particular topic or to explain some action the company has taken.
3. Dealer's news letters.
4. Posters for display in company or dealer showrooms regarding some special topic.
5. Special letters to employees, stockholders, and others.
6. Radio broadcasts, particularly of programs which are of general public interest and not too commercial.

I am not going to try to develop the advantages or disadvantages of these various ways by which consumers and the public can be reached. I think each has its place in particular situations. In some cases, it is desirable to use several forms for the same project in order to obtain overlap coverage. The significant point is that these methods of communication are specific in nature and being designed for special purposes in which the consumer is already interested, should prove relatively effective and successful.

The second realm of information requiring reports to consumers about industry's prices, costs, and profits is the more difficult one because of its general nature, because of its technical aspects, and because the consumer just isn't much interested in it. Yet some knowledge is essential to a comprehensive understanding of the subject, and industry must do its best toward effectively reporting thereon. I think the basic message which business hopes to convey to the public in relation to prices, costs, and profits is somewhat as follows: Under our free enterprise system of business in the United States, profits are an essential element of continuing progress. Satisfactory profits can only be obtained by maintaining a proper relationship between the prices which a company charges for its products and the costs of production and distribution which it incurs in making them available. Costs can be controlled only within restricted limits. The primary means of producing this proper relationship, therefore, lies in the price structure.

In some lines of business it is necessary to change prices frequently because of wide fluctuations in the material element of their costs. Generally speaking, however, most industrial companies attempt to follow a policy of fairly stable prices through relatively long periods. This means that the prices will remain more or less fixed even though there may be minor fluctuations in costs. However, when major changes in material or labor costs occur, and when these are not offset by other factors such as increased volume of production, prices are usually changed. Stability of prices, therefore, does not usually indicate the same degree of stability of costs.

An important characteristic of a price policy is the profit objective of a company. Prices must of necessity be sufficient, over the years, to recover costs of production and operation plus some profit. I am assuming that this is a fundamental fact. The question which may be debatable is the profit objectives used by business in establishing selling prices. I think that profit objectives should be:

1. To pay an adequate return to stockholders in order to justify and encourage the continuance of their investment in the business. This should give due weight to the effect of inflation.

2. To provide, in addition to dividend requirements, amounts for retention in the business to meet the capital required for its normal growth. Practically all business must keep their products up to date and must introduce new and better lines of products to meet consumer demand. Unless a business is able to do this, it ceases to be progressive and gradually loses ground.

3. In a period of inflation such as we are now experiencing, there is generally a third requirement which should be met in profit objectives, and that is to provide the amounts needed to enable the business to operate in the same scope and volume as before. Business must constantly renew itself to remain effective, and in order to do this, the integrity of its capital must be maintained. I shall discuss this in more detail later.

A profit objective when related to total investment indicates the desired return on investment. The attainment of this return on investment is dependent upon two factors: First, the margin of profit on sales, or as it is sometimes expressed, the percentage of profit to the net sales proceeds; second, the rate of turnover of capital through sales, or the percentage of net sales proceeds to the capital. Expressed as a formula—margin of profit $\times$ rate of turnover $=$ return on investment. Since the final objective is the return on investment, it becomes necessary to estimate what the volume of business will be under normal conditions in order to ascertain the desirable margin of profit required to attain this goal. Obviously, a percentage of return on investment which is adopted as a profit objective should be one which can be obtained, as an average, over a fairly long period of years. This necessarily implies that the actual return in exceptionally good years will be substantially higher than the objective, and the actual return in poor years will be substantially lower. This formula possibly suggests that the margin of profit should be uniform for all products. Practically, of course, this is impossible. Deviations are necessary to meet the competitive situation with regard to many of the products. It is, therefore, important to know the cost picture thoroughly on individual products in order to be in a position to make necessary deviations intelligently.

Profit objectives are expressed not only for the over-all picture, but for important groups of products which can be related to definite production units. For example, all the products of a particular plant might constitute one such group. Obviously, to be able to establish the profit objective in terms of return on investment, it is necessary to predict normal sales volume by classes of products with some degree of accuracy. It is also essential to know what investment is required to produce the results anticipated.

It might be objected that unless a company had the utmost freedom to set prices unhampered by competitive considerations, it could not hope to attain a desired profit objective over a long period. However, if a company has products of real economic value to offer, and if such products have been efficiently produced and distributed, the play of competitive factors should certainly not prevent the attainment of this objective. In fact, the forces of competition should stimulate improvements in manufacturing efficiency and in distribution or in design to help bring this about.

The profit margins of many concerns are substantially lower now than they were prewar, and yet, despite this, the return on investment is considerably greater. This, of course, has been made possible by the high volumes of business which are currently being enjoyed by most companies. There is a danger in assuming that this abnormal volume of business will continue indefinitely. Companies which have made break-even studies are aware of the much higher break-even points which exist today as compared to the prewar era, due to lower margins of profit and higher fixed costs. A modest drop in volume will cause some companies to be faced with losses. There is a great deal of uncertainty as to when present-day volumes will ultimately level off to some postwar normal basis, and as to what these postwar volumes may be. The influence of the present programs for rearmament and for the Economic Cooperation Administration may have the effect of prolonging these abnormal volumes for some time to come.

All of this, however, increases the uncertainty as to when the adjustment will come, and as to what degree it will affect business.

The economic growth of the country, up to the beginning of the last war, was accompanied by substantial increases in wage rates, both in "money" wages and in "real" wages measured in terms of purchasing power. The increase in "real" wages was made possible because of gains in productivity arising from technological improvements. Consequently, these substantial increases in wages did not generally result in increased prices, and as a matter of fact, did, in many instances, result in lower prices because of increased productivity.

Increases in wages since the war have been more rapid than increases in productivity. This has been reflected in higher labor costs per unit of product as well as higher costs of materials, components, and services purchased from other employers of labor. These higher labor costs have stimulated the installation of more labor-saving equipment to bring about increases in productivity. This in turn has called for greater managerial skill and the investment of more capital for additions to plant and equipment, all of which are tied up with the question of adequate profits which I intend to discuss a little later.

The expression "ability to pay," which was coined a few years ago and which was used by labor officials and by some men in government circles, was accepted more widely than is generally appreciated. It is still difficult for many individuals to understand why it wasn't possible to pay these annual rounds of wage increases without disturbing the price structure. One of the reasons for this difficulty is that the percentage of labor costs in relation to sales prices within a given company may be rather low and may appear to be an unimportant item in the price structure. This overlooks the fact that the labor cost within any one enterprise is not the entire cost of labor represented in the final price. It is only an installment of a series of wage costs, beginning with the first cycle in extracting or handling raw materials, continuing through all the steps of processing and transporting, and ending with the final product. It is probably true that total labor costs represent at least 80 per cent of the final price to the consumer, and, therefore, any general increase in wages must inevitably affect prices, even in those companies whose own labor costs appear low.

It is my belief that industry has not done enough to point out to the public the necessity for keeping the industrial machine efficient and up to date, in order to promote continued prosperity. The key to the situation is efficient and sustained production. To attain efficient and sustained production it is important that more and more tools of production be added to the economy. The investment in tools of production per employee is higher in the United States by far than in any other country. Past experience has demonstrated that as the investment in tools per employee increases, the rate of production and the standard of living also increase. When business invests in such tools, it contributes toward economic growth and economic growth means prosperity in the future. Tools of production can be added to the economy only if business is profitable.

I think it is unfortunate that management is too often apologetic about profits. There are some concerns which, undoubtedly, earn profits which are not entirely reasonable, particularly when full recognition is given to the factors which produce these profits, and when consideration is given to all of the uncertainties regarding the reality of profits in a period of inflation. All companies should strive for adequate profits and should be prepared to defend them. Without adequate profits there cannot be economic progress. In the last analysis, profits mean more work and better pay for employees, more goods and relatively lower prices for customers, and more attractive dividends for stockholders.

I should like to discuss briefly the significance of profit figures in an inflationary period. This revolves around the question of whether there is not a substantial difference between "monetary" earnings as reported by corporations under generally accepted accounting principles, and what might be termed "economic" earnings. This question arises because of the effects of inflation upon the value of inventories and upon the replacement costs of fixed properties. Inventories for a given company may have remained the same during a year insofar as quantities or units are concerned and yet the total dollar value may have increased substantially because of inflation. In such a situation, more of the company's capital is tied up and a large part, or perhaps all of the "monetary" profits as reported, is not available for dividends since it is required for working-capital purposes. A similar situation occurs with respect to the increased replacement value of plant and equipment. Property purchased prior to the war will eventually have to be replaced. Such of the property as must be replaced at inflated values will require the investment of substantially more capital than has been made available by accumulated depreciation reserves. Consequently, to the degree that retained profits were necessary to provide for the added replacement costs of property, it can very well be argued that such amounts do not represent "economic" profits but merely an amount necessary to restore the productive capacity of the company. Obviously, if a company is not able constantly to renew itself and maintain the integrity of its capital investment, it must inevitably lose ground and if this continues, it will eventually fail.

Much has been written about this subject and many ways have been proposed to deal with it. I am not going to suggest which of these ways is most acceptable, or whether it is necessary to depart from current accounting procedures. With all of the disagreement which exists today between accountants, economists, and businessmen as to how we should deal with this subject, it is too much to expect that the average consumer will appreciate the technical aspects of this problem. However, it is quite within the province of a company in its annual report or in its public statements to point out that the net income for the year is affected by these factors, and that there is a greater need in such times to retain a higher percentage of earnings, after payment of appropriate dividends, in order to maintain the financial strength of the company.

Let us now consider what might be reported to consumers with respect to these technical aspects of "prices, costs, and profits." One of the reasons for reporting to consumers is to assure them that the goods they buy are at fair prices, and that the management of the company which produced them is paying adequate wages and dividends and is operating the business in a manner which should contribute to the economic welfare of all groups involved. This job cannot be done successfully solely through the use of statistics. However, there must inevitably be some presentation of figures in order to tell the business story. The question is what kind of figures should be presented, what form should they take, and how much of the business story can be made of real interest to consumers and the public. In my opinion, any statistics which may be given to consumers should be simple, easily understood, and of a character which emphasizes relationships rather than absolute figures. In expressing essential relationships it is desirable to avoid standard accounting terminology. Everyday expressions should be used.

Having in mind that industry's presentation of such a technical subject to the public should be as simple and understandable as possible and through such media as annual reports, press releases, and institutional advertising, I should like to suggest that the statistical part of the story include one or more of the following:

1. Profit margins; that is, the relationship of net profit to sales or gross revenue, and comparisons with the previous year and a prewar year.

2. Profit returns; that is, the relationship of net profit to the capital investment.

3. Profits retained; that is, the net profit retained for use in the business after payment of dividends.

4. Analysis of receipts to show how much was expended for materials, employment costs, taxes, dividends, etc., and how much was retained in the

business. This should be presented in percentages or in chart form. A further breakdown might be developed to show how much was distributed to employees and to stockholders after payment of materials, taxes, etc. This would give some indication of the rather high relationship of pay rolls to the total amount available for employees and stockholders.

5. Comparative statistics of a current year with a prewar year to show percentage of increase in wages, in prices of basic materials, in cost of living, etc., as contrasted with the increases in prices of the company's own products.

6. Investment per employee. The purpose of this is to show how much of a capital investment is required for each employee in order to carry on operations.

The above suggestions are by no means complete. The important point to keep in mind is to confine the report to a few basic relationships of importance presented in as simple a way as possible.

In addition to statistical presentations there are, of course, many other matters which might be interesting to consumers and should be considered in industry reports. Among these might be the following:

1. Relations with labor, particularly at times when some major change has occurred. This might include new contracts with unions, effect of strikes on employment and supply of goods, increased wages, employee plans, etc.

2. Production outlook, particularly in times of critical shortages. Consumers do not always appreciate the reasons for such shortages.

3. Factors which are causing increased costs and which, therefore, may affect selling prices.

4. Explanation of the necessity for adequate profits; its relationship to future capital requirements; also the effects of an inflationary period upon profits.

5. The role of the stockholder, and the necessity for maintaining a fair dividend policy consistent with the profits and the needs of the business. Stockholders are an unorganized group and yet the total number of stockholders of the 15 largest industrial companies in the United States is actually greater than the total number of employees of these same companies. Unless stockholders are fairly compensated with due recognition to inflation, it will not be possible to attract capital for the future needs of the business.

6. The role of small business institutions. Many consumers are indirectly concerned with the welfare of small business. Many of them have a feeling that small businesses are operating under definite disadvantages and that sooner or later they will be destroyed or absorbed by big business. The managements of most large companies realize that the business of this country cannot be carried on by large companies alone. They recognize that, in the best interest of the country, we must have both large and small companies, that their own interests are not necessarily antagonistic, but, frequently, complimentary. It is not generally appreciated that, in the aggregate, small companies play a most important part in the economy. For example, government statistics show that approximately 98 per cent of the manufacturing establishments in this country have less than 500 employees each, and that they represent, in the aggregate, nearly two-thirds of the total employment in industry.

So much for this general, more technical field of information in which the consumer is naturally not much interested but in which he should be educated because of its fundamental nature. I think it is evident why reporting in this field is considered to be of uncertain effectiveness. Certainly, no immediate or definite results therefrom can be anticipated. This type of reporting must be of a long-range nature, but is, basically, of the highest importance, and should be assiduously pursued.

Some Examples of Industry Practices and Reports as Affecting Consumers

Let us consider briefly some practical applications of industry reports to consumers. In the first place, most people, and, therefore most consumers, are a bit hazy in their thinking of fundamental economics. Many of them have no appreciation of the concept of the three-way relationship which exists between corporations and their employees, customers, and stockholders. Business organizations represent a medium for the production of wealth that should have for its objective the equitable division among customers, employees, and stockholders of the wealth and benefits it creates. It is somewhat difficult to express such an idea to the public, but it is an important concept which individual companies should be able to substantiate, and which should be explained to the public.

I now wish to consider three indirect but important methods that industry should not overlook as mediums for effectively promoting favorable relations with consumers; namely, through employees, dealers, and the community.

The employee organization is certainly an important medium for this purpose. A company should not lose sight of the necessity of keeping employees informed. This should begin with the company's own supervisory and managerial staff. It frequently happens in the pressure of day-to-day problems that managerial employees are not informed of policy changes or important decisions. Unfortunately, such employees frequently hear of these decisions by the gossip route which invariably distorts the facts. If we expect to keep customers informed, it is even more important to keep our supervisory employees informed. As for nonsupervisory employees, they, too, have an important stake in the decisions made by management and they should be informed of these, as well as given the results of operations from time to time. Satisfied employees, adequately informed about their company's business, constitute, often without realizing it, a valuable contact medium with the consuming public, and, potentially, represent a very substantial and effective influence toward popularizing their company and its products.

Another important medium for fostering good consumer relations is the distributing organization or dealers. They should, by all means, be informed in advance of any matters of importance affecting supply, prices, services, etc., through dealers' letters, posters, etc. It should be borne in mind that in communicating with dealers it is not enough merely to tell them what is happening. It is more important to tell them the reasons for certain business policies and the circumstances which affect the decisions. Customers look to their dealers as being competent to speak for the producing companies, and their opinion of a company is greatly influenced by their appraisal of the company's dealers.

The third important medium for developing desirable relations with the consumer is the community itself in which a company operates. It is difficult to think of any approach that would have a more direct effect than that of permitting customers of an industrial company to learn at firsthand through observation about the company and its operations. This may be done by arranging for plant visits in the community. The company might arrange for an open house when all of the operations may be seen and visitors may be given a complete view of the processes of manufacturing. Visitors should be given an opportunity to obtain booklets which give them more information about the things they have seen, and which may be read at a later time. Such plant visits, if properly handled, develop in the public a sense of community pride, and help to instill confidence in the company's management.

Many companies are making use of institutional advertising. A few recent examples will illustrate such uses.

The United States Steel Corporation announced, a few weeks ago, a $25,000,000 reduction in selling prices on many grades of steel used for consumer products. General Electric sometime previously announced price reductions on many consumer items. In a recent report, General Electric stated: "The most important task to which the company is setting its hand in 1948 is engineering, manufacturing, and selling standard products of the electrical industry at a fair profit but at the greatest value and at the lowest price." The Standard Oil Company of New Jersey ran a full-page ad immediately after the release of its annual report, the heading of which was: "A Report on the Biggest, Hardest, Most Useful Year We Ever Had." It commented on oil production, the difficulties caused by the hard winter, increased costs, company earnings, money spent for new equipment, increased research, and labor-management relations.

International Harvester Company has made the following matters public statement which appeared in many newspapers throughout the country:

In 1946 an advertisement was run showing Harvester profits earned during the war, as well as in prewar years, and compared these profits with the opinions of the public as developed by the Opinion Research Corporation.

In March, 1947 price reductions on most of their products, representing an aggregate savings to customers of $20,000,000 per annum, were announced.

More recently a statement was made on black market practices, the reasons for it, how it operates, their opposition to it, and urged cooperation by dealers and customers to correct it.

Immediately after the release of the 1947 annual report to stockholders, a large ad setting forth a few of the high spots appearing in the report, such as the increase in employment, the increase in wages, the increase in production, the increased volume of goods produced for customers, the increase in dividends to stockholders, and the decrease in margin of profit in relation to sales, was published. The ad closed with the following statement: "We believe 5.5 cents per dollar of sales is a reasonable rate of profit. We know that it is our continuing ability to earn a reasonable profit which has made it possible for International Harvester in 1947 to serve more people—employees, customers, and stockholders—in greater measure than ever before."

In conclusion, let us consider the objectives we are seeking in making reports to consumers. If we are realistic, we must not expect that even a small percentage of the public will remember statistical facts or operating relationships. The most that we can hope for is to create favorable general impressions, and those only by constant repetition of a limited group of ideas. The public speaks of certain companies as being good companies; some companies are not spoken of so favorably. If we could analyze the reasons for these reactions, we would probably find that they represent many individual impressions. Among these impressions might be a customer's own satisfaction with certain products purchased, or with the quality of service received, or he might have been influenced by various public relations statements appearing in newspapers, magazine articles, annual reports, etc. It might be the result of impressions he gained from friends who are working for the company or who are stockholders of the company, or from individuals living in the community in which the company operates. It would be most unusual for a consumer to build up a favorable impression of a company solely because he had read a public relations statement which seemed to ring true. What I am trying to say is that while such statements are of importance, it requires something in addition to all this in order to influence the customer favorably and lastingly. It is not enough to have a good public relations department. What is more important is to build up integrity and good will so that employees, dealers, customers, stockholders, and community neighbors are unofficially spreading good public relations in the company's behalf. Such a desirable objective can be attained only by business management which is forward-looking, conscious of its social responsibilities, and which is actively *practicing* good public relations.

FIFTH SESSION

SATURDAY, MAY 22, 1948—10:00 A. M.
Hagerty Hall Auditorium

Chairman:

THOMAS W. LELAND, *Professor of Accounting, Texas A & M College; President, American Accounting Association, College Station, Texas*

Address: "Recent Trends in the Federal Tax Field"

THOMAS J. DOLAN, *Partner, Wideman, Madden, Dolan & Company, Toledo*

Address: "The Effect of Present Tax Structure upon the National Economy"

MASON SMITH, *President, National Association of Cost Accountants, Chicago, Illinois*

RECENT TRENDS IN THE FEDERAL TAX FIELD

By Thomas J. Dolan
Partner, Wideman, Madden, Dolan and Company, Toledo, Ohio

I deem it an honor to appear on this program once again, and I am happy to be here to discuss my views with a group of understanding fellow accountants.

Some time ago, I was listening to a luncheon speaker in Toledo. It seems he had addressed that same club on the subject of salesmanship on at least one previous occasion, but because of a change in business connections between visits, all of the members did not recognize him. When he began to speak, however, one member did recall his previous visit and left in the middle of the talk, exclaiming, "The same old story, just like the Bible, the same yesterday, today and tomorrow!"

In some respects Federal taxes are likewise the same old story, but we cannot quite say, "the same yesterday, today and tomorrow." It must be admitted they existed yesterday, in fact, to such an extent that no living adult will forget them in this or his next lifetime. They certainly exist today, and we all know that their impact is such that they are among the most dominant factors to consider in arranging our business and financial affairs. That they will exist tomorrow, have no doubt; hence our query, "In what manner are they changing and what are their trends?"

Generally speaking, the only interest the average person has in this subject is in what can be done to reduce his personal burden. He is not greatly concerned whether the changes are in the interest of the nation, or how they may affect business, or even society as a whole. Also, the average person is primarily interested in his present tax position and is not too concerned with a long-range program. This is not quite the case, however, with a relatively small group of our citizens, to which select group you must belong, for otherwise you would not take your usual week-end leisure time to listen to technical discussions, and exchange views with other members of your profession. Possibly this is in line with an observation I recently heard expressed by a banker who stated, "There is more ability, sincerity, integrity and industry in and among professional accountants than in any other professional group." I consider this statement to be highly complimentary, and it is probably true because we accountants today play a leading role in advising businessmen and bankers, and are forced to be more alert, dispassionate and sincere than we would otherwise be. Since Federal taxes are now such an important segment of every business transaction, we must study not only the tax laws of today, but anticipate the tax laws of tomorrow. In other words, we must know the trend in the Federal tax field.

It is very difficult to form fixed opinions hastily on such a broad subject as our general chairman, Mr. Miller, assigned to me, particularly when we consider that taxes are, to a degree, a political football and a means of social reform; that much of the success or failure experienced in our national economy depends upon over-all national tax planning; and when we consider that tax programs are changed frequently so as to accommodate such emergencies as our new national defense program, our new program of aid in world recovery, and our sudden awakening to the need for support of our democratic way of life as opposed to Communism. These factors all have a direct bearing on Federal tax plans, but so do other economic factors such as farm income, retail sales, the volume of our exports, construction activity, the demand for and conservation of our natural resources, social reform programs and many other things. It may be difficult to see at a glance that all of these points have been considered heretofore in connection with tax planning by Congress, but it is quite evident when we read the reports of the Finance Committee and the Ways and Means Committee; when we see how amortization of war facilities developed, how depletion came to be the tax gift that it is to oil producers, how the recent community-property principles were considered not only for income tax purposes but for estate and gift tax purposes as well. Yes, our Federal tax laws have a definite plan and purpose other than raising revenue. They are developed from many points of view, by much labor on the part of many groups, and after great brains follow the course of the river from the headwaters to the ocean. At times, in the course of my studies of taxation, I have been as confused as some of our legislators appear to be when they discuss a specific tax problem. However, after musing over the problem time and time again, I have come to some definite conclusions; and without attempting to cover the field in too great detail, and without confining myself to a discussion based alone on cited cases, on economics, or on administration, I shall proceed within the time allocated me to give you some specific points as I see them.

Since taxes seem to engender so many arguments or mental battles, let us liken our study to a prize ring and place one major emphasis in each fighter's corner. If we do so, we will consider the problem from two broad points of view, one of which is political and legislative, and the other, administrative and judicial.

Politically, this is an election year. It has been forecast in polls and by political dopesters as the year when Dewey's slogan of four years ago—"It's time for a change"—should be used. Right or wrong, it is generally conceded to be a Republican year, and the basic tax program of that party will probably be enacted as law whether or not a Republican president is elected. The extent to which all of the campaign promises may or may not be carried out is unimportant. The Republicans have been advocating tax reduction in one form or another since the early 1930's, excepting the war years, and it is now a well-recognized fact that they are anxious to go into the coming campaign on a record of constructive tax action and tax reduction. The 1948 tax reduction bill, passed over Presidential veto, is tangible proof and positive campaign material as to the intent of the party. In the earlier bills, which failed to muster sufficient strength to override the vetoes, the trend was established, and the bill which recently became law probably provides for equally as large reductions in individuals' taxes as were proposed in the earlier bills. This was accomplished by a series of political maneuvers, compromises, etc., including adoption of the community-property feature in income, estate and gift taxes.

In studying tax trends for the immediate future, such changes in law as are advocated by the Republican party seem important, and it is likewise important to note that many Democratic congressmen voted for each of the proposed bills. This, too, is such a radical change from the attitude prevalent during the past fifteen years that it is significant. The social changes which took place during this period were, in a measure, reflected in the various tax bills; after which, of course, the war requirements distorted all tax thinking to the theme, "Take the profit out of war." The extremely high tax rates imposed during war periods cannot, of course, be considered as a tax trend, but it is not easy to shake off the inflationary philosophy developed during the war. For a long time to come, we shall have to be on guard against a noisy group, in the minority we hope, that would use taxation as a means of destroying our fundamental "profits system."

The Congressional desire for tax revision following the war is best illustrated by the appointment of the Special Tax Study Committee, headed by Roswell Magill. The Special Committee was appointed by the Ways and Means Committee, pursuant to resolutions passed by the House of Representatives, to enable Congress to obtain the advice and counsel of this group of experienced tax men so that the general revision of the

Internal Revenue Code, undertaken by Congress, might be such as to develop a beneficial structure for our post-war economy, eliminate inequities, create incentive, encourage production, etc. The committee report stated, in part: "The primary consideration in making our recommendations has been the effect on the welfare and economic prosperity of the country as a whole and the maintenance and development of our American system of private enterprise for the welfare of all the people. . . . The equitable adjustment of tax rates and exemptions is a No. 1 Federal tax problem today."

With the foregoing statement as their general theme, the now familiar Magill report went on to make specific recommendations covering, in part, the following subjects:

1. The community property principle
2. Double taxation of dividend income
3. Taxation of small corporations
4. Net loss carryovers
5. Intercorporate dividends and consolidated returns and related tax penalties
6. Change of burden of proof under Section 102
7. Stock purchase plans of employees
8. Exchanges in corporate reorganizations

There were, of course, many other important recommendations pertaining to income, estate and gift taxes, but those mentioned seem to bear out the fact that there is new political thought being given the taxation problem. Judging from the foregoing, from the changes embodied in the 1948 Revenue Act, and changes not yet enacted but already agreed to by the Treasury and the Ways and Means Committee for enactment in the next revenue bill, it seems fairly conclusive that, from the political viewpoint at least, a new and favorable trend in taxation is discernible. As our esteemed friend, Professor Paton, said several years ago on this very platform, "We have been on a zig-zag. We have had enough of the zig, now let's try the zag."

The legislative trend naturally follows the political trend, but there are distinctions of note which should be called to your attention. Politically you have the ballyhoo, the appeal to the masses, the work of the lobbyists for special interests, the compromises which exist in all political undertakings, and often some lack of sincere purpose.

When it comes to the actual drafing of legislation, the Committee on Ways and Means, its staff, the staff of the Joint Committee on Internal Revenue Taxation and Treasury experts give great weight to the results of hearings and studies which extend over many months. It is then that large numbers of persons are heard, their articles read, committees such as the tax committees of the Bar Association and the American Institute of Accountants, the National Association of Manufacturers, labor leaders and others express their views; and from the combined views and reports, important conclusions are drawn and legislation results. Public statements of the Secretary of the Treasury would lead to the conclusion that Treasury experts desire to maintain war-time taxation rates and all the inequities which have crept into and become law over a period of years. Their actions prove the contrary to be true. Listen to a portion of the text of a letter addressed to the Chairman of the House Ways and Means Committee on February 26, 1948, by Mr. A. L. M. Wiggins, Under Secretary of the Treasury:

> As you know, Secretary Snyder has urged in appearances before your Committee the desirability of undertaking at the earliest possible opportunity the steps necessary to eliminate from the tax structure its inequities and administrative and other defects. Under present conditions we cannot safely undertake this year some of the basic structural changes that will ultimately be desirable due to the large losses in revenues they might entail. I am confident, however, that we can adopt many revisions which would move in the direction of a much improved postwar tax system.

Accompanying this letter were the Treasury's recommendations on 49 items. They included many of those in the Magill report and embraced net loss carryovers, employee stock options, reduced taxes for small corporations, several recommendations for technical adjustments, and others. Whether or not there is enough time left during this session of Congress to complete the technical task of drafting a bill embodying the presently proposed changes is another matter. I doubt if there is sufficient time, due to the early date of the political conventions and starting of the campaigns. This is unimportant, in my opinion, as my conclusions are that the political and legislative trends are definitely toward tax reduction, toward tax equality between residents of all states, toward required tax consideration tending to stimulate and create business incentives, toward elimination of inequalities and inequities, toward simplification, toward elimination of many technicalities, and toward complete revision of the Internal Revenue Code which has not been done since 1942. While our enterprise system has functioned with outstanding and amazing success, it cannot do so indefinitely unless our house is in order. Every indication is that we are fully cognizant of this requirement, and what is more important, something is being done about it. It can now be said without doubt or fear of contradiction, politically and legislatively, that the trend is favorable and towards a sounder economy.

We now have knocked out the fighter in the "political and legislative corner" and will move to the "administrative and judicial corner." Our next major consideration in this study of trends must be from the standpoint of administration by the Bureau of Internal Revenue, and interpretation by the Courts.

Were the discussion to revolve around experience with individual cases, this meeting would last all day, and we could, without question, cite interesting favorable and unfavorable situations and reactions. To fairly judge the matter, however, it seems necessary to abandon our so-called field experiences and study the problem from the point of view of policy in the Treasury and the Bureau.

Generally speaking, I think the governmental agencies responsible for administration of the tax laws do a pretty good job. Many of the persons employed have a great amount of ability, and I am at a loss to understand how some of the personnel is retained with what I consider to be inadequate compensation. This does not mean that the administration cannot be substantially improved, and I think the officials would be the first to make such an admission. I also think it goes without saying that when the Congress makes more progress in simplifying the tax statutes, better administration will follow.

Bureau officials, in their interpretation and administration of tax statutes, appear to accept decisions of the United States Supreme Court as binding, unless some purported facts can be distinguished. Otherwise, decisions of the Tax Court and the District and Circuit Courts are disregarded if inconsistent with determined policies.

A careful reading of the Commissioner's arguments in defending or appealing some cases would certainly confuse the layman unfamiliar with tax practice, because it is not unusual for him to issue rules and regulations holding one way and to argue a contrary view in the courts. Then, too, it is rather common practice for the Commissioner to appeal decision after decision through the lower Courts on the same point if the Courts interpret the law contrary to Bureau policy. Frequently, by repeatedly litigating the same question, some Court eventually agrees with his contention; and finally, after sufficient conflict exists in the Appellate Courts, the matter reaches the Supreme Court where occasionally the Commissioner is granted even more than he asks. Then legislation is required to clarify the issue. Examples of this practice, which is quite annoying to tax practitioners and more so to taxpayers, are the attacks on family partnerships, the frequent attempts to tax corporations for the appreciation in property distributed to shareholders, the battle which has raged for years over the question of whether or not practically all corporate distributions are equivalent to taxable dividends, the question of what constitutes a tax-free reorganization, the never ending litigation on trusts, and so on and on until it is with fear and trepidation that a positive opinion is given on any tax matter of consequence. And this does not necessarily end with a Supreme Court decision, because it is difficult to have identical facts in two cases.

While such procedures and policies are quite annoying to say the least, each of us would probably act in exactly the same manner were we charged with the responsibility of protecting the revenues. You and I can and do accept such practices with full knowledge and understanding of the Commissioner's position, but how frequently have you had a client curse and swear and proclaim what he would do to that "so and so" if he ever had the opportunity! Likewise, each of us can cite instances where legitimate business transactions are never consummated because of uncertainty of tax consequences, inability to obtain a ruling in time to effect a closing, where heavy interest charges accrue on proposed deficiencies year after year, awaiting Circuit Court and Supreme Court decisions.

In his zeal to protect revenues, the Commissioner seems to have drifted a little from the administrative into the legislative field. In some cases, he has tried to establish a new concept of law which, in effect, would compel the taxpayer to follow procedures that would result in the greatest amount of tax rather than the old concept of minimizing taxes. In some Section-102 cases, he has contended that the taxpayer should make use of his borrowing capacity for working capital needs or expansion, and thus make hard-earned profits free for distribution as dividends. At no place in the statues is such a concept even suggested.

My firm now has an interesting Section-102 case in which the Commissioner is trying to make a brand-new law. Company A was formed with a cash capital of $250,000 and borrowed $1,000,000 on a 15-year term loan. It then used this $1,250,000 to purchase the entire capital stock of Company B. Shortly after the purchase, Company B, the wholly owned subsidiary, was merged into its parent. After the merger, the surviving parent company had the usual assets and liabilities of a going concern and, in addition, had the $1,000,000 term debt. I wish to point out that, as far as I have gone, this merger is specifically tax free under the statutes and was not questioned by the Commissioner. But now we come to Section 102, and here the Commissioner refuses to recognize the fact that the surviving company has a large debt payment that it must meet each year for 15 years, and insists that the profits could have been distributed as dividends to such an extent that insufficient cash would have been left for debt service. Now, if the transaction had not been set up in the way that I have described, in order to minimize taxes, it could never have been made. If the stockholders, as individuals, had arranged to borrow the $1,000,000 and had been forced to look to dividends for the cash with which to pay their loan, their personal income taxes would have taken so much away that the loan could not be repaid. The point that I want to stress, however, is that the Commissioner is trying to inject a brand-new concept in applying Section 102, something that is not even remotely suggested in the statutes. It has always been my concept of the statutes that anything may be done legally which is not specifically prohibited. In the case to which I have referred, if the Commissioner should succeed in the Courts, it will be ruinous to the taxpayers to say nothing of the bank having a bad loan. Even if the Commissioner does not succeed, the case will take a long time in going through the Courts, during which time the corporation will have hanging over it the threat of a ruinous tax assessment, with interest, and during which period its credit standing must necessarily be impaired.

Since decisions of the Commissioner are subject to judicial review, I believe we can state that the administrative trend in the Bureau is legalistic in approach, and that policy decisions anticipate judicial interpretation in all cases except where the Treasury is in accord with existing statutes. Equity, consistency and sound business policy are absent in the tax administration departments of the government; technical and legalistic attitudes prevail, yet more and more the trend appears to follow the political trend, and at top level, considered opinions reflected in recommendations to Congress indicate desire for simplification and constructive revamping of the entire tax structures. This is definitely a trend in the desired direction.

Respect for our Courts is most essential under our form of government, and I dislike making any comments that will in any way detract from them. What is said here today, if at all disrespectful, is not so meant. The thought I wish to convey is simply that our Courts do not always decide issues equitably, consistently, and with certainty and finality. I believe there are trends in their decisions, too, which belatedly follow political and economic trends. One most interesting case which bears out this conclusion is that of Joseph Sunnen, decided April 5, 1948, by the U. S. Supreme Court. While the principles of law enunciated on the facts in that case were not too important, the principle that "emphasis," and "legal climate," and changes in economic trends can result in a new decision on the same statutory language and the same documents is important. If you question my statement that there are trends in judicial decisions, please read the April 5, 1948, decision of the Supreme Court in the case of "Commissioner of Internal Revenue, petitioner, v. Joseph Sunnen." I think it good evidence of a requirement which is fundamental in tax planning today, namely, a "new look" at decided cases, with a view to studying trends in the decisions. In fact, Justice Murphy said as much when he held, in substance, that while intervening and later decisions did not establish entirely new principles of law, they did change the "emphasis" and the "legal climate" sufficiently to destroy the binding effect of earlier decisions. The Court also said in that case that the doctrine of *res judicata* or collateral estoppel is not meant to create vested rights in decisions that have become "obsolete" or "erroneous with time." (Perhaps we should have said "with the times" instead of "with time.") Another important principle enunciated in that case which should be called to your attention is contained in this sentence, "For income tax purposes, what is decided as to one contract is not conclusive as to any other contract which is not then in issue, *however similar or identical it may be.*"

There goes your "certainty" out the window. Normally, you would think you have the right to rely with certainty upon consistent treatment of an item involving identical issues and documents unless there was a change in the statute. Not so, says Justice Murphy in the Sunnen case, if times are changed, if other decisions change the "emphasis." Do not misunderstand me—I do not contend this is new law or a new change in judicial policy. I simply mean that there are trends in the judicial phase of our problem too. No one will deny that former President Roosevelt recognized this fact. Remember the stories on "the nine old men" and the battle over "court packing." The New Deal court-packing did not work directly, but by reason of the long tenure of office of Roosevelt and the New Deal Democrats, appointments to the bench during the past fifteen years give rise to a different class of thinkers in the judiciary. The tendencies of these appointees, in many cases, leaned toward the views of the appointors, a very natural thing; and the interpretation and construction of the tax statutes followed the theme of the New Deal, that is, more socialistic, or more liberal, or whatever the words they use to describe their social philosophy. In any event, it was almost a sin to have the means to be in business. Business practically lost its voice in affairs and seemed afraid to come out of its shell, possibly because of its earlier wrongdoings which could not well be placed on the screen. The war, of course, changed the whole picture. Businessmen proved they were necessary, had ability and were, in the national interest, willing, to use some slang, "to get in there and pitch." This last war was the war of production, and because we had the plant, the know-how and the will to work, we won the war. The war restored a lost confidence in businessmen, caused everyone to take note of our economic affairs, caused many jurists to "see the light" in their thinking and move towards the conservative rather than the liberal view, become less restrictive and narrow in their interpretations and recognize the basic fact that in our economy and in our way of life, both capital and labor are essential. The war may or may not be responsible for this change in trend but the timing is coincident. The pendulum has completed one arc of the swing and is now in the return arc. I hope it does not go too far the other way, and I do not think we need have too much fear of such an eventuality, at least during the lifetime of those present at this meeting today.

My time is running out so I must bring this to a close. I have attempted to place before you the change in trend in Federal taxes as I see it. There are trends of course, and the road signs are there to be read. They are a matter of interpretation, and, unlike Will Rogers, we must not confine our thoughts to what we read in the newspapers. To illustrate just that one point, take the 1948 changes which have now become law. All of the news services, radio broadcasts and newspapers heralded the reduction in rates applied to individuals in the very low brackets and to withholding. Why? Millions of people were involved, it was good news, and something the multitude wanted to hear. The community-property change for some in the higher brackets was important, but the greatest change for encouraging production by creating incentive, and to me the change of most importance, was hardly mentioned. That change was the 50 per cent marital deduction allowed under the estate tax law. Relatively few are involved and thus the publicity was negligible. Nevertheless, even in my limited acquaintance I know more businessmen who have been given a new urge and greater desire to accumulate wealth and build an estate as a result of this one change in the law than all of the others combined.

It has been a pleasure to appear on this program, and I wish to thank Chairman Miller for inviting me to do so. Remember that favorable trends in taxation are greatly influenced by alert and clear thinking groups of tax practitioners such as the members of the Ohio Society of Certified Public Accountants. I thank you.

THE EFFECT OF THE PRESENT TAX STRUCTURE UPON THE NATIONAL ECONOMY

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In view of the excellent program which this fine conference has produced year after year, and which has been repeated again this year, I find it hard to believe that I can adequately cover this important subject so that my remarks will make a fitting close to the technical sessions of the conference.

When Professor Miller asked me to take this subject, I made it very clear to him that I knew very little about taxes. In fact, the only thing I felt very sure about in this field was that, personally, taxes were too high. After some discussion with him it appeared that some pertinent ideas might be developed concerning the effects of our tax philosophy for the past fifteen years as I have observed it in dealing with a rather wide range of types and sizes of businesses over most of that period.

Before this topic can be discussed, it seems necessary to me to reach tentative agreement concerning some basic characteristics of our national economy. It is obvious to any student of history that the development of our economy since we became a nation has been neither consistent nor perfect. We have had continuous swings from one extreme to the other, whereby, for the time being, certain interests or groups gained temporary ascendancy and temporary material advantage over other groups. We have had our full share of speculative booms and speculative busts. We have combined great affluence in the hands of the temporarily powerful few with widespread economic distress of many, for relatively short periods. It is easy, therefore, for any student of history to point a critical finger at the evils which have displayed themselves as we have developed into a state of semi-maturity as a nation. If these evils are utilized by visionary planners or those of intellectual dishonesty, they can also become the basis for some plan of economy which, it is hoped, will in the long run eliminate them. Whether the means of elimination of these evils through such efforts are helpful or harmful to a degree which more than offsets the benefits of those same evils is a never-ending, moot question. In other words, if we agree that the country bowed too much to the power of capital from 1890 to 1929, I think, in all fairness, we must say that we have bowed too much to the power of labor and to that illusory thing called "The good of the common man," since March 4, 1933. Or, if we say that our individualism was too rugged and too ruthless during the building period of the railroads, the utilities and our giant industries, we must, in my judgment, in all fairness, say that our individualism has been too circumscribed during the past fifteen years. It seems timely, therefore, to pause and consider what our tax philosophy of the past fifteen years has done to some of the essentials of our national economy.

The term, "our national economy," means to me that system by which we put together, in a broad sense, the forces of production to satisfy the needs and desires of our people. While that system never has and, probably, never will operate perfectly, it seems pertinent to consider the effect of our tax structure upon it, in the light of the strengths and weaknesses in it, in terms of the types of economic opportunity and economic problems which appear to face us. I shall, therefore, consider, during the remainder of the time at my disposal, the effects of our tax philosophy on some of the major elements of production.

We are all familiar with the generally unfavorable attitude toward business which appeared and reappeared too frequently during the 1930's. In 1933 the country chose to elect a President who by his words, but more particularly by his actions, believed more in the power of the state to conquer our economic ills than in the power of the individual to conquer them. Whether our emergence from the depression of the early 1930's would have been on a more healthy basis than many believe it was, had we followed the philosophy of less faith in government, no one will ever know. Certainly one effect, however, of that change in the place of government and its relation to business had a very marked effect on the introduction of capital in the expansion of existing businesses and the launching of new ones. Between 1929 and 1939, for example, as reported by the *New York Sun* in its issue of January 5, 1948, the dollars of investment per worker in industry declined from slightly in excess of $6,000 to slightly in excess of $5,000. In my judgment, at least a part of this failure to increase investment per worker must be attributed to the feeling of a somewhat jittery business community with reference to relations with the Government. The first effect on the national economy of our tax philosophy, therefore, is that we have made the return on capital so small, and we have increased the influence of Government on business so greatly that capital has not flowed into industry even in the prewar years to an extent that kept an adequate supply of new, modern and improved production facilities coming into the market place.

It is self-evident that the country's growth in productivity per worker has been accomplished largely through the improvement in the tools placed in the hands of the worker, and the willingness of the stockholder and the management to invest capital in such tools with the hope of a speedy and adequate return. Since the burden of taxes reduces to a material degree the possibility of adequate returns from such investments properly to compensate for the risks involved, it is my opinion that one of the most detrimental and significant effects of our tax structure on the national economy is the promotion of a period of gradual liquidation.

A second area of significant effect of our tax structure on the national ecnomy lies in the operation of business. It has been my experience on many occasions, as I am sure it has been yours, that the long period of relatively high taxes with a consequent growth in greater and greater areas of Government service on which business might lean has changed the concepts of planning and control which used to be thought essential. We all know that our economy operates under the effects of a number of subsidies, and in the last analysis, every business transaction involving expense may be looked upon as partly subsidized, because of the relatively high proportion of the expense which is paid for in tax dollars. As a result, it has been my observation over the past several years in business after business, that there is not the same degree of careful financial planning and careful control of costs that are necessary for survival in an economy of more complete individual initiative. The minds of our executives and subexecutives are poisoned with the virus of loose expense handling, because if we saved the dollar through better expense handling, we would keep only a small fraction of it. We as accounting people have to stand up to that general tendency and educate our executives and our clients to the facts of a tax-blighted life. Probably never in the lifetime of any man in this room can we expect such a reduction in the costs of Government and taxes that those taxes will be considered a minor expense. If we must live with them, let's all do the best we can to live with them realistically. So the second effect of our tax structure on our national economy is, in my judgment, one of making us less and less careful operators in business, allowing our business to go along in a sort of flippant atmosphere which disregards those habits of thrift, planning, and saving which were prominent motivating forces during the long building period of the nation's economy.

The third general area in which, I believe, there is a significant effect of taxes on the national economy is in the general field of the development and maintenance of an adequate number of seasoned executive personnel. I believe we would all agree that as the country matures, the very difficult job of carefully operating our matured and semi-matured industries is upon us. For example, it takes a very different type of ability to build a business from its inception to a point of maturity or semi-maturity than it does to operate that business profitably after it has emerged from its promotional period. I can think of one business here in the middle west in which I have had the opportunity to observe this phenomena at work very closely. The business was started some thirty years ago with an original capital of $500, and, through the almost religious zeal of its originator, it has reached a position of dominance of its market, yet it has not made a satisfactory return on sales or investment for the past several years. The ability of the zealous entrepreneur often is not transformed into ability as a careful operator and merchandiser. We have seen numerous examples of that type among our own clientele. It seems self-evident to me, therefore, that our business atmosphere ought to be attractive to those men who have an ability to *run* businesses where competition becomes keener, margins become narrower, and the rate of return per dollar of sales may go down. But our tax laws apparently are not drafted with that thought in mind. For example, the last proxy statement of a large company stated that the president was paid a salary of about $100,000 a year. After taxes the statement indicated that his take-home pay was about $30,000 a year. Since his company is a leader in its industry and he is, therefore, a prominent, large corporation executive, it is probably safe to assume that after he has paid the expenses inherent in his position, he will be lucky to have left in cash $5,000. As the tax laws are presently written, it is possible for him to make more money for himself in one good capital-gains deal than he will ever accumulate as president of that large business. In my judgment, therefore, one of the worst effects of our present tax laws is the effect on the development of mature, careful operating and control types of executives. How long it may take for men of executive capacity of this type to forego the satisfactions of power and accomplishment in the face of opportunities for capital gain is a question which cannot be answered here. When we have a tax structure which places such a heavy hand on the development of those very abilities of which we will need an increasing supply as our economy matures, is it logical to expect that the supply of trained, seasoned executive talent will be adequate?

We are all familiar with the various means which companies have adopted in an attempt to overcome this problem. Corporate boards have drawn "deferred compensation" contracts with certain executives, which, in effect, oblige the company to keep the executives, and the executive to keep on rendering enough service after a given age to qualify for his deferred compensation. Should a present Board commit all future Boards in this way? If the tax laws allowed an executive to keep a more equitable portion of his income, would it not be better for him and the company to be somewhat more independent? I think so.

We also see many other tax-dodge methods of executive compensation every day: Cadillacs for the major executives; mixing enough business in with a trip to Cuba to make the trip qualify as business "for tax purposes" when it is nothing but a good old-fashioned vacation; providing ample expense accounts for which the executive doesn't have to render an accounting. Are these and other devices like them the sort of business practices which place great emphasis on forthrightness, thrift, and care in handling money out of which real business stature grows! Must we continue this sort of soft-shoe dance in order to make our big executive jobs financially attractive?

A major factor in the change in philosophy of government in 1933 was the belief that the country had reached a point where the individual could no longer shift for himself. We were told that our economy was mature; we were told that our future was one of dividing up what we had, rather than creating more; we were lulled into a sense of false security based upon the general thesis that there was plenty in the country for everybody without creating more, if we would only distribute it equitably. Why the great masses of the people should have fallen for such nonsense is hard for me to understand, but they did. Having sold that "starry-eyed" idea, the leaders of that thought in Government proceeded to implement a part of the program by the passage of a tax law which they didn't call a tax law. They named it Social Security. Stripped of its trappings, the masses of the people have been led, through this law and its aftermath, gradually but surely away from the basic concept of the individual providing for his own security to the concept of seeking security in the Government, or in some external agency. We now have great masses of people who have paraphrased the old saying "The Lord will provide" into the motto "The Government will provide." On the basis of this thesis, we have great numbers of our people interested less and less in the gains which they might make from intelligent risk-taking and interested more and more in seeking a haven which promises security, and seeking it at a younger and younger age. It is my judgment that we cannot have the fruits of free enterprise without the acceptance by many individuals of the risks of free enterprise. We will not generate that driving force which brings out the best capacity of people if, at too early an age, we get them thinking about the supposed serenity of retirement furnished by a benevolent Government. In other words, I do not believe it is possible to subsidize the risks inherent in free enterprise, and at the same time to expect the profits which can come from free enterprise if those risks are borne by the individual. I use Social Security as an illustration because it affects the largest number of individual persons.

To a somewhat lesser but a very important degree, the other subsidizing processes and bailing-out agencies which have been created by the Government and are supported by taxes, have, in my judgment, a similarly bad effect on the strength of our economy. In my father's day, if he were in the livery stable business and wasn't smart enough to get out in time and take over the Ford agency, he probably went broke. Today there would undoubtedly be some means by which, either directly or indirectly, he could find Government surcease from the pains of an entrepreneur gone wrong. The whole process, therefore, of propping up the individual and underwriting business risks, all of which are supported by taxes, is, in my judgment, having a most profound effect on the development of our people and the growth of an ability on their part to render service commensurate with their inherent capacity, because the stress of developing that inherent capacity to the fullest has been taken away to a greater or lesser degree, depending upon the individual.

Closely akin to the growth in concepts of external security in the Government, we see the great wave of retirement plans and other similar devices. Great care is always exercised to be sure that annual contributions under these plans are deductible for tax purposes. Somewhere around in the mind of management lurks the thought that the retirement plans is good, partly at least, because it can be paid for in cheap dollars. Many of these plans have been established during the war years. When the inevitable shaking out process comes; when the businesses which looked sound during the war turn sour; when the company can't pay its retirement fund contributions—what then? What of those people who placed their faith in the management's decision to have a plan? Have they not been led astray by faulty thinking, due very largely to our tax laws?

A fifth effect of our present tax structure on our national economy lies in the direction which taxes give to the final resting place of individual incomes. Based upon the general idea of dividing what we have instead of creating more, we have gone along for years under the general theory of soaking the rich. Our government has believed that the capacity of an individual to earn a high income should make him the marked target for the carrying of a disproportionate per capita share of the tax burden.

Somewhere along the line we seem to have overlooked the fact that the inherent ability to *earn* a large income might carry with it a companion ability to *utilize* the *fruits* of that income for a generous contribution for both individual and social gain. Let me illustrate. I have a friend in Chicago who graduated from college in the late 1920's as an outstanding electrical engineer. During the war period, on more than one occasion, he took products on a sub-contract from one of the large companies and was able to re-design that product and make it a better product, freely admitted by the large company. He has great creative and developmental ability, and is in every respect an excellent businessman. Our tax philosophy, however, has made it impossible for him to build a business commensurate with his inherent ability. The Government control boys will point to the fact that they have made it impossible for him to become a millionaire. I prefer to look at it another way. They have also made it impossible for a man with great ability to build a business employing thousands of people instead of a few hundred. Is it socially desirable for the country to have one new industry with all of its flow of profits, goods and jobs, or is it more desirable to so thwart the ability of the individual that neither he nor the country gains the industry or the fruits therefrom? Rather than allow him to accumulate a sizable personal fortune in the process of building a company, we have formed tax laws which direct the fruits of industry to a larger and larger degree into the hands of the masses. Theoretically, this should increase purchasing power; theoretically, this should allow people who have not had sizable personal incomes to enjoy products which they were not able to enjoy in the past; theoretically, this should enable people to build individual estates. But has it worked that way? I think there is ample evidence to indicate otherwise. By placing such a large share of the money income of the country in the hands of people who have never learned how to use that money income properly, we find ourselves so diluting the possibility of constructive saving that, in effect, we are squandering that income. Where will we turn, if these present trends continue, twenty or twenty-five years from now to find the pools of individual capital which can be tapped for such worthy enterprises as a local hospital, a church, a public playground, etc. If you answer that the government will subsidize those things, my answer is that if we retreat as individuals to the point where our local pride and our local ability to take care of ourselves is given up, we must have lost some of the ability which is a requirement to make an economy such as ours continue to work. And so it seems to me that the tax structure which lightens the burden on the relatively low income producer diverts saveable income into too many hands without adequate ability to keep it from becoming spent income. For the good of the country, in terms of the creation of a supply of capital and its wise investment, the tax burden should be materially lightened on the person who has capacity to earn high income and the judgment to use the fruits of that income wisely. The burden of taxes should fall to some degree on everyone and should be heavy enough on the low income producer to divert that portion of surplus which, falling into his hands, does not repair the capital damage to the country.

As a sixth effect we have, of course, the spectre of an expanding Government bureaucracy, supported by the heavy burden of taxation. We are all well aware of it, but we don't know what to do about it. We are hopeful that the efforts of such statesmen as Senator Byrd and former President Hoover can mean something tangible. Unless a statesman-like approach is made we face a perilous situation, in my judgment, in which we are attempting at one and the same time to tax our people for military necessities, for the imposed costs of the late war, for relief and rehabilitation of foreign countries and for activities which might be desirable to certain groups but which are not a dire necessity. We cannot be expected to pay taxes for all these things without seriously impairing the standard of living of our people, and starting a movement which will dry up the very source of the taxes themselves. Only by a realistic approach to the reduction in the cost of Government, such as is being made by the Hoover Committee, can we hope to bring those costs down to a supportable and necessary level.

As a last effect we have the plain old-fashioned production slowdown on the part of many people of capacity. Here is a nation in need of constantly higher production; in need of expansion through greater capital investments; in need, in short, of the maximum application of the brains of its citizens in business. Yet the tax laws make it very difficult to keep one from saying, "Why exert myself—the Government will get X per cent of what extra I'll make and if I lose, I'll take the rap." Apparently, it isn't attractive to the American businessman to go into such a partnership arrangement. Until we face up to the fact that people of ability must be able to keep at least 50 per cent of the *marginal* income which they might make through full employment of their capacities, our economy will not be as strong as we have the brains to make it.

This subject is so extensive that we could spend the whole day and still not exhaust it. I have attempted in these few minutes with you to bring out some of the effects of our tax system in some of their broader aspects. In summary, it seems to me that these effects are self-evident:

1. Through the processes that I have described we have been living off the capital of the country and we are doing little or nothing to generate new capital or make it attractive for new capital to be invested in enterprises.

2. We have lived so long with dollars of expense paid for at varying percentages through our tax laws that we have in many quarters a serious disregard of proper means of controlling expense of our business.

3. The maturing economy of the country in many industries demands highly skilled operating and control types of executives. The return to the executive for the application of those talents which the country most needs is so disadvantageous as compared to the return to the promoter of capital gains that, in my judgment, we are losing ground in the development of such executive talent.

4. We have an over-developed idea that the individual need no longer seek security himself, but can rely upon security provided by Government. In my judgment, that has tended to kill initiative; to kill the adventuresome spirit; to kill the will to succeed without which we will not be generating the best abilities from the brain-power of our people. In short, we cannot have the fruits of a virile private enterprise without the individual's accepting the greater share of the risk in partial return for his right to receive a greater share of the profits.

5. We have some slow-down in production of the brains of our people.

6. The program of heavy taxation has lulled our people into the acceptance of a hideous government bureaucracy. We must awaken our people to that fact; we must realize we cannot support all of the necessities in our budget as well as the niceties to certain groups without seriously impairing our ability to maintain our standard of living. The only effective way to eliminate the things which cause this hideous bureaucracy is to shut off the income which supports it. That means, of course, reductions in the amount of taxes.

I am well aware that many people argue the necessity of high taxes as a hedge against inflation. Unless persons in power under our form of government do differently in the future than they have in the past, money collected in taxes will be spent. I see little difference in the effect on inflation whether we leave the money in the hands of the individual to be spent, or whether we take it from him in taxes and spend it as a government.

It seems to me, therefore, that if we believe that the best hope of survival of a strong America lies in a strong economy, we must stop doing those things which weaken the fibre of that economy at its base and start doing those things which will place incentive where it belongs to make our economy strong. That economy will be strong if we can have an atmosphere that will attract capital to expand existing business, to improve the processes of existing business and to generate new business. That economy will be strong if we adjust the tax laws on individuals so that persons of great ability can profit greatly, but in the profiting can create pools of capital which can be wisely invested in new ventures and provide the economy with added jobs, cheaper products and a better standard of living at the debatable, socially undesirable cost of allowing a few men to make a million dollars. Our economy will be strong if we generate adequate judgment-forming executive ability. Without the guidance of that kind of ability it makes little difference whether we continue as individual enterprisers or whether we continue under some form of government ownership. There is no substitute for brains as the directing head of business or government. The people, and the *whole* people, pay a terrible price when those brains do not exist and find real effect. Our economy will be strong if our people accept the responsibilities of individuals as they learn to lean on themselves and not on a government. Without the process of leaning on themselves they will not generate sufficient resourcefulness to bring out their latent capacities. If our people do not develop to their utmost our economy is being held back. Our economy will be strong in somewhat direct proportion as we remove the heavy hand of government, lighten the burden of taxes, and accept as individual people the responsibilities which go along with the opportunities which are inherent in our free enterprise system.

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